No. 82-1200 filed 1/17/83

IN THE

Supreme Court of the United States

October Term, 1982

DAILY INCOME FUND, INC. and
REICH & TANG, INC.

Petitioners,

v.

MARTIN FOX,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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January 14, 1983

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Question Presented for Review

Is a shareholder's derivative action under § 36(b) of the Investment Company Act of 1940 exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure?

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Petitioner, Daily Income Fund, Inc. ("the Fund") respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on October 26, 1982.[1]

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1 Reich & Tang, Inc., the investment adviser to the Fund (and the other defendant in this action) supports this petition in all respects. Pursuant to Rule 28.1 of the Rules of this Court, the following is a list of all parent companies, subsidiaries (except wholly owned subsidiaries) and affiliates: the Fund—none; Reich & Tang, Inc.—August Associates and Centennial Associates.

Opinions Below

The opinion of the District Court (Hon. Kevin T. Duffy) is reported at 94 F.R.D. 94 (S.D.N.Y. 1982). The opinion of the Court of Appeals is reported at 692 F.2d 250 (2d Cir. 1982). Both are reproduced in the appendix to this petition.[2]

Jurisdiction

The judgment of the Court of Appeals was entered on October 26, 1982. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

Statutes Involved

The statutes and rules involved are Section 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b) and Rule 23.1 of the Federal Rules of Civil Procedure ("Rule 23.1").

Statement of the Case

Respondent, a minority shareholder of the Fund, a money market fund, instituted a derivative action under § 36(b) of the ICA against Reich & Tang, Inc. ("the Adviser"), the investment adviser to the Fund, to recover allegedly excessive advisory fees. The Fund was also named as a defendant.

The Board of Directors of the Fund consists of five individuals: three unaffiliated directors and two who are

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2 All page references to the appendix are in parentheses and are followed by the letter "a."

affiliated with the Adviser. Thus, a majority of the Board of Directors of the Fund is unaffiliated.[3]

No demand was made by respondent on the directors to obtain the relief he desired. Respondent simply took matters into his own hands and, without advance notice, commenced litigation, allegedly on behalf of the Fund, in violation of the director demand requirement of Rule 23.1.

The Fund promptly moved to dismiss the action for failure by respondent to comply with the director demand requirement of Rule 23.1, and that motion was granted by the District Court. The District Court reasoned, based on a thorough review of the legislative history of the ICA, that ". . . under the statutory mandate the board of directors of an investment company is to be the first line of defense for the individual investor against any self dealing into which an adviser might be tempted." (5a). The District Court therefore held that ". . . a Rule 23.1 demand is a *sine qua non* in this type of litigation." (5a).

On appeal, the Court of Appeals reversed, holding that Rule 23.1 does not apply to actions brought under § 36(b) of the ICA. The Court of Appeals reasoned that § 36(b) actions are not derivative because an investment company does not itself possess the right to bring an action against its adviser for return of allegedly excessive fees.

This petition followed.

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3 The unaffiliated directors are: W. Giles Mellon, Professor of Business Administration in the Graduate School of Business Administration, Rutgers University; Alan J. Patricof, head of a private investment corporation and Dr. Yung Wong, managing Director of a venture capital investment firm. The affiliated directors are: Joseph H. Reich, President and Treasurer of the Fund, and Oscar L. Tang, Chairman of the Board and Secretary of the Fund.

Reasons for Granting the Writ

The decision of the Court of Appeals—holding that actions under § 36(b) of the ICA are exempt from the director demand requirement of Rule 23.1—is in direct and irreconcilable conflict with the recent decisions of two other federal courts of appeals on the same matter, i.e. the Courts of Appeals for the First and Third Circuits: *Grossman* v. *Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, ___ U.S. ___, 103 S.Ct. 85 (1982); *Weiss* v. *Temporary Investment Fund*, ___ F.2d ___, CCH Fed. Sec. L. Rep. ¶ 98,865 (3d Cir., Nov. 12, 1982).

In addition, the Court of Appeals has decided an important question of federal law (i.e. the appropriate interrelationship of two federal statutes, the ICA and the Federal Rules of Civil Procedure) which has not been, but should be, settled by this Court.[4] The decision, while appearing to be merely procedural, effects a substantive change in the law with far-reaching consequences. Further, the decision is in conflict with the rationale of *Burks* v. *Lasker*, 441 U.S. 471 (1979), and, if permitted to stand, will undermine the fundamental principle of corporate self-governance in the mutual fund industry.

Finally, the decision of the Court of Appeals rests upon a faulty central premise, i.e. that an investment company itself has no right of action under § 36(b) and, therefore, a shareholder's action under § 36(b) is not truly derivative and does not trigger the director demand requirement of Rule 23.1. This premise is erroneous and does violence to

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4 As the Court of Appeals itself noted, resolution of the issue has "important ramifications for suits brought pursuant to § 36(b)." (15a).

the language of Rule 23.1, to the purpose of the ICA, and to this Court's recent rulings on implied rights of action.

In sum, a writ of certiorari should be granted because the decision of the Court of Appeals: (1) creates a conflict between the circuits; (2) involves an important question of federal law which has not been, but should be, settled by this Court, and (3) is erroneous.

I.

Two other federal courts of appeals have decided the precise issue presented herein, and both have reached the opposite conclusion from that of the Court of Appeals for the Second Circuit. After careful consideration, the Courts of Appeals for the First and Third Circuits rejected every argument relied on by the Court of Appeals for the Second Circuit and held that a demand on the directors is required in a shareholder's action brought under § 36(b) of the ICA. *Grossman* v. *Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, ___ U.S. ___, 103 S.Ct. 85 (1982); *Weiss* v. *Temporary Investment Fund*, ___ F.2d ___, CCH Fed. Sec. L. Rep. ¶ 98,865 (3d Cir., Nov. 12, 1982). These opinions are also reproduced in the appendix to this petition.

The conflict between the circuits is direct and irreconcilable on this important matter.[5]

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5 All three decisions were rendered in 1982. The Second Circuit noted in this case that its decision conflicted with that of the First Circuit in *Grossman* (23a), and the Third Circuit noted in *Weiss* that its decision conflicted with that of the Second Circuit in this case (80a).

II.

The decision below, if allowed to stand, will undermine the fundamental principle of corporate self-governance embodied in the ICA.

The 1970 amendments to the ICA make clear that it was Congress' intent to preserve and strengthen, rather than eliminate, the role of the unaffiliated directors with respect to advisory fees. The Senate Report, which is the basic document in the legislative history of § 36(b), states:

> "These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary."

S. Rep. No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Admin. News 4897, 4902-03.

Thus, as this Court recognized in *Burks* v. *Lasker*, 441 U.S. 471, 484-85 (1979):

> "In short, the structure and purpose of the ICA indicate that Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders." (footnote omitted)

The District Court below similarly recognized that Congress' intent was to make the board of directors of an investment company "the first line of defense for the individual investor against any self-dealing into which an adviser might be tempted." (5a). Allowing a shareholder to bypass the board of directors and bring a § 36(b) action without even making a demand upon the directors is inconsistent with that purpose.

The director demand requirement is based on a policy favoring exhaustion of intracorporate remedies. As this Court held in *Hawes* v. *Oakland*, 104 U.S. 450, 460-61 (1882), before a shareholder may commence a derivative action,

> ". . . he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes."

This same purpose is the basis for the demand requirement of Rule 23.1:

> "The purpose of the demand requirement of Rule 23.1 is to allow a corporation to activate intracorporate remedies to address shareholder complaints prior to resorting to judicial intervention."

Mills v. *Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D.Ill. 1981). See also *Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153, 157-58 (D.Mass. 1973); *Weiss* v. *Sunasco, Inc.*, 316 F.Supp. 1197, 1206 (E.D.Pa. 1970); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171 (1976).

In view of the oversight role with respect to advisory fees which Congress gave to the unaffiliated directors of an investment company, the policy of exhaustion of intracorporate remedies has especially clear application to shareholder's derivative actions brought under § 36(b) of the ICA.

Faced with a timely demand, the directors can respond in a number of ways. If they find the claim has merit, they can (1) negotiate with the adviser to obtain a return of fees, (2) terminate the contract if the adviser refuses, and/or (3) institute a § 36(b) action.[6] If the directors find the claim lacks merit, they might nevertheless succeed in avoiding litigation by convincing the complaining shareholder that the fees are reasonable or that litigation would adversely affect all shareholders' interests.

In sum, the ICA imposes upon the directors the duty to evaluate advisory fees. To exempt § 36(b) actions from the director demand requirement of Rule 23.1 would allow a single shareholder to bypass the duly elected directors and force an investment company into expensive and time-consuming litigation. In this era of burgeoning caseloads, the director demand requirement is a particularly important protection against expensive and possibly unwarranted litigation.

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6 The Court of Appeals held that an investment company cannot itself bring a § 36(b) action. As shown below, that holding is erroneous. Moreover, even if an investment company has no right of action under § 36(b), a shareholder's action is still derivative and Rule 23.1 still applies. The other alternatives open to an investment company allow it an opportunity to resolve the shareholder's grievance without resort to litigation.

III.

The central error in the Court of Appeals' decision is its conclusion that an investment company does not itself have a right of action under § 36(b)[7] and that, accordingly, a shareholder's action under § 36(b) is not (in the words of Rule 23.1) one "to enforce a right which may properly be asserted by it." (18a). That holding ignores this Court's decisions as to the applicable framework for determining whether a statute creates an implied right of action and conflicts with the fundamental purpose of the ICA.

A.

In *Cort* v. *Ash*, 422 U.S. 66, 78 (1975), this Court held that the following factors should be considered on the issue of a statutory implied right of action:

> "First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,'—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is

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7 The Court of Appeals also relied for its holding on this Court's suggestion in *Burks* v. *Lasker, supra*, 441 U.S. at 484, that directors may not terminate suits under § 36(b). The Court of Appeals reasoned from this premise that the traditional reasons for a director demand do not apply. (36-37a). However, as just demonstrated, that conclusion does not follow, because a demand furthers the policy behind the exhaustion of intracorporate remedies even if the directors cannot terminate a § 36(b) action.

the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law."

Last term, this Court placed the following gloss upon the framework set forth in *Cort*:

> "In determining whether a private cause of action is implicit in a federal statutory scheme when the statute by its terms is silent on that issue, the initial focus must be on the state of the law at the time the legislation was enacted. More precisely, we must examine Congress' perception of the law that it was shaping or reshaping. When Congress enacts new legislation, the question is whether Congress intended to create a private remedy as a supplement to the express enforcement provisions of the statute. When Congress acts in a statutory context in which an implied private remedy has already been recognized by the courts, however, the inquiry logically is different. Congress need not have intended to create a new remedy, since one already existed; the question is whether Congress intended to preserve the preexisting remedy." (footnote omitted)

Merrill Lynch, Pierce, Fenner & Smith v. *Curran*, ____ U.S. ____, 102 S. Ct. 1825, 1839 (1982).

The Court of Appeals in this case did not specifically evaluate any of these factors. Although it recognized that the legislative history of § 36(b) was silent as to whether an investment company could bring an action to recover excessive advisory fees, it construed that silence as militating against an implied right of action (29a). Its rationale for that conclusion was that "[t]he relationship of

a fund to its adviser makes it part of the problem in a way that precludes it from being part of the solution, at least at the litigation stage." (34-35a). That conclusion is premised upon a fundamentally unsound view of the purpose of the ICA, as set forth in the legislative history and as interpreted by this Court in *Burks* v. *Lasker, supra.*

As this Court recognized in *Burks,* the thrust of the 1970 amendments to the ICA was to increase the participation of the unaffiliated directors in the operation of mutual funds. To deny the directors an opportunity to exercise that power would undercut the whole Congressional effort to enhance the role of unaffiliated directors. Although *Burks* dealt with a different ultimate issue, it aptly appraised the role Congress assigned to the unaffiliated directors in the 1970 amendments to the ICA:

> "Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." (footnote omitted)

Burks v. *Lasker, supra,* 441 U.S. at 485. Thus, an implied corporate right of action under § 36(b) is not at all inconsistent with the purpose of the ICA. To the contrary, it furthers the role of the directors as "watchdogs" and provides another means (in addition to suits by the SEC and shareholders) to recover excessive advisory fees.

Since an implied corporate right of action furthers the purpose of the ICA, the Court of Appeals for the Second Circuit erred in construing Congress' silence on this matter as indicating an intent to deprive an investment company of the right to bring an action against its adviser.

In addition, the Court of Appeals overlooked the state of the law at the time Congress enacted § 36(b). The common law predecessor to a § 36(b) action was a shareholder's suit against the adviser for "corporate waste," which was clearly derivative. 13 W. Fletcher, Cyclopedia of the Law of Private Corporations ¶¶ 5924, 5926-27 (rev. perm. ed. 1980). Moreover, a shareholder's implied right of action under former § 36 of the ICA (now § 36(a)), was uniformly held to be derivative. E.g. *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); *Brown* v. *Bullock*, 194 F. Supp. 207, 245 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961). In light of this background, Congress can and should be presumed to have known in 1970 that an investment company had its own right of action against its adviser.[8] Since there is no evidence that Congress intended to abolish this pre-existing right of an investment company to bring an action to recover excessive advisory fees, the Court of Appeals erred in holding that an investment company has no right of action under § 36(b).

B.

Even if (contrary to our analysis) an investment company does not itself have a right of action under § 36(b), a shareholder's action under § 36(b) is derivative and must be preceded by a director demand.

Rule 23.1 requires director demand "[i]n a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly

8 "Where Congress adopts a new law incorporating sections of a prior law, Congress can be presumed to have had knowledge of the interpretation given to the incorporated law." *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, *supra*, 102 S.Ct. at 1841 n. 66.

be asserted by it. . . " Neither the language nor the purpose of Rule 23.1 supports the Court of Appeals' holding that an action is "derivative" only if the right that a shareholder seeks to enforce is one that the corporation could assert *in a lawsuit*. That holding confuses the concepts of "right" and "remedy." Regardless of whether an investment company has a *remedy* under § 36(b)—it is beyond dispute that it has a *right* not to be charged excessive advisory fees.

Under § 36(b) a shareholder is permitted to bring an action against an investment advisor "on behalf of" an investment company. This provision clearly makes a shareholder's action derivative. As this Court noted in *Burks* v. *Lasker, supra*, 441 U.S. at 477, "[a] derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation." (emphasis supplied) This Court then went on to refer to § 36(b) suits as "derivative". *Id.* at 484.

Moreover, the policy underlying the director demand requirement of Rule 23.1—that of favoring exhaustion of intra-corporate remedies—is applicable to a shareholder's action under § 36(b) regardless of whether the investment company can itself bring such an action. As demonstrated above, the directors of an investment company have a number of methods to resolve a shareholder's grievance concerning advisory fees without resorting to litigation. The Court of Appeals set at naught these other remedies because of its belief that, as a practical matter, they would not be effective (19-20a n.7). That belief is unsupported and conflicts with the whole purpose of the ICA to make the unaffiliated directors the "independent watchdogs" of an investment company's interests. *Burks* v. *Lasker, supra*, 441 U.S. at 484.

In sum, the central premise of the Court of Appeals' decision is erroneous: an investment company has its own right of action under § 36(b), and even if it does not, a shareholder's action under § 36(b) is derivative and must comply with the director demand requirement of Rule 23.1.

Conclusion

For the foregoing reasons, a writ of certiorari should issue to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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January 14, 1983

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APPENDIX

Decision of the District Court

No. 81 Civ. 2602 (KTD).

United States District Court,
S. D. New York.

March 29, 1982.

MARTIN FOX,

Plaintiff,

—v.—

REICH & TANG, INC. and Daily Income Fund, Inc.,

Defendants.

Money market investment company shareholder brought derivative action against the company and the investment adviser to the company to recover allegedly excessive advisory fees paid by the company to the investment adviser. On the defendants' motion to dismiss, the District Court, Kevin Thomas Duffy, J., held that: (1) the shareholder was required to make demand on the company board of directors prior to bringing suit, and (2) the shareholder's failure to make such a demand was not excused by his unsubstantiated allegtion that all the company directors were involved in the wrongdoing and were necessarily hostile to his claim.

Motion granted.

Milberg, Weiss, Bershad & Specthrie, New York City, for plaintiff; Richard M. Meyer, New York City, of counsel.

Seward & Kissel, New York City, for defendant Reich & Tang, Inc.; Anthony R. Mansfield, New York City, of counsel.

Pollack & Kaminsky, New York City, for defendant Daily Income Fund, Inc.; Daniel A. Pollack, Edward T. McDermott, Frederick P. Schaffer, New York City, of counsel.

OPINION & ORDER

KEVIN THOMAS DUFFY, *District Judge*:

Martin Fox, a shareholder of Daily Income Fund, Inc. ("Fund"), sued the Fund, a money market investment company, and Reich & Tang, Inc. ("R&T"), the investment adviser to the Fund, to recover allegedly excessive advisory fees paid by the Fund to R&T. Plaintiff's derivative suit is premised on Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), which places a fiduciary duty on an investment adviser with respect to compensation for services.[1] R&T is alleged to have breached that duty.

1 15 U.S.C. § 80a-35(b) provides in relevant part:

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or

Defendants move to dismiss plaintiff's complaint for failing to plead that a demand was made on the Fund's board of directors prior to the filing of its complaint. Federal Rule of Civil Procedure 23.1 expressly states that a derivative suit complaint:

> shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort.

Plaintiff concedes that no demand was made and suggests that Section 36(b) does not require such a demand.

The issues presented to this Court are two-fold: one, whether a demand is required in a Section 36(b) action and, two, if a demand is mandated, whether plaintiff is excused from the strictures of Fed.R.Civ.P. 23.1. The

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by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

* * * * * * *

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

answers to these questions have apparently resulted in a split within this district. Judge Ward recently held in *Markowitz v. Brody, et al.*, 90 F.R.D. 542 (S.D.N.Y.1981) that Section 36(b) does not obviate the need for a Rule 23.1 demand. In direct contrast, Judge Lasker states in dictum that "a demand on the directors of the Fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital Inc., et al.*, 528 F.Supp. 1152, 1155 (S.D.N.Y.1981). Plaintiff argues that the *Blatt* decision should control this case for the following reasons: (1) the board of directors inability to terminate a Section 36(b) action renders any demand futile; (2) the legislative history supports plaintiff's contentions; and (3) a suit maintained under Section 16(b), an analogous section, need not comply with Rule 23.1. I do not find any of these arguments to be persuasive.

DISCUSSION

Before I begin to address plaintiff's three arguments, I must start my discussion of the question presented neither with the particular section of the Investment Company Act in issue nor with the Federal Rules of Civil Procedure, but with the overall congressional intent behind the Investment Company Act and its requirement that there be "unaffiliated" persons on the board of directors of investment companies. Clearly in mandating this type of membership on the decision making board of an investment company, Congress recognized the need for protection of investors from unscrupulous investment advisors who might be in a position to mulct the public investor. The advisor to an investment company is entrusted with enormous amounts of money collected from the public shareholders and also with the day-to-day management of

those funds. S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News, 4897, 4903, 4910. The temptation for self dealing whether through inflated fees or other nefarious schemes is self-evident.

It was to inhibit such self dealing that Congress insisted that directors unaffiliated with either the investment advisor or the Fund's principal underwriter constitute forty percent of the board of an investment company, 15 U.S.C. § 80a-10. "Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds [including the Daily Income Fund] are unaffiliated with their managers." S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News at p. 4901. Thus, under the statutory mandate the board of directors of an investment company is to be the first line of defense for the individual investor against any self dealing onto which an advisor might be tempted. *Fogel v. Chesnutt*, 668 F.2d 100 at 104 (2d Cir. 1981); *Moses v. Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed. 2d 547 (1971).

To require that an individual shareholder must first bring a problem to the board of an investment company therefore is not unreasonable. The unaffiliated directors can easily solve the problem (if it be real) without the need for litigation and its concomitant expense to the investment company. Thus, absent extraordinary circumstances, a Rule 23.1 demand is a *sine qua non* in this type of litigation. To hold otherwise is to rule that the congressional enactment of the Investment Company Act is, in the main, ineffective, and the arguments advanced by plaintiff do not lead to such an anomalous result.

1. *Termination of a Section 36(b) Suit*

Mr. Fox correctly states that a Section 36(b) suit cannot be terminated by the Fund's board of directors. *Burks v. Lasker*, 441 U.S. 471, 484, 99 S.Ct. 1831, 1840, 60 L.Ed.2d 404 (1979); *Markowitz, supra*, 90 F.R.D. at 559. However, it does not logically follow that this safeguard obliterates any need for compliance with Rule 23.1. Even assuming, as plaintiff suggests, that the Fund's board of directors, which consists of three disinterested and two interested members, are hostile to his claim, this is not adequate justification for abandonment of the Federal Rules of Civil Procedure. The underlying basis for imposing the demand requirement on a derivative suit plaintiff extends beyond providing an opportunity for director termination. Directors should be given an opportunity to redress an aggrieved plaintiff without resort to litigation, *Untermeyer v. Fidelity Daily Income Trust, et al.*, 79 F.R.D. 36, 42 (D.Mass.1978), or to institute a private right of action themselves.[2] Acceptance of plaintiff's argument would foreclose any opportunity for prelitigation director involvement and as such is untenable.

2. *Lesiglative History*

Mr. Fox's bare contention that a demand on the Fund director's in a Section 36(b) suit is futile and consequently unnecessary and unreasonable, is not sufficient reason to ignore Rule 23.1. A "statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." 7 Moore's *Federal Practice* ¶ 86.04[4] at 4966.

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2 It is unsettled whether or not the directors are empowered to maintain a private right of action. *Fogel v. Chestnutt*, 668 F.2d 100, 112, (2d Cir. 1981); *Markowitz, supra*, 90 F.R.D. at 557 n.12; *Untermeyer, supra*, 79 F.R.D. at 46 n.30.

Section 36(b) silence on the necessity of demand on the directors assumes compliance with Rule 23.1. The Federal Rules may, however, be superseded by congressional enactments that "abridge, enlarge or modify any substantive right." 28 U.S.C. § 2072.

> [I]t is plain to the Court that a security holder's right to sue under Section 36(b) would in no way be modified or abridged within the meaning of 28 U.S.C. § 2072 simply by requiring compliance with Rule 23.1 . . . Section 2072 is not triggered by an instance where application of the federal rules would be unreasonable, but only in a case where the rules directly conflict with substantive rights. No such conflict exists here.

Markowitz, supra, 90 F.R.D. at 555.

The legislative history provides scant basis for concluding that statutory disharmony exists with the traditional demand requirement. Plaintiff cites passages from a Senate Committee Report expressing guarded concern for the directors' ability to "secure changes in the level of advisory fee rates in the mutual fund industry." H.R.Rep.No.2337, 89th Cong., 2d Sess. (1966) at 131. Congress's proper concern with the issue of investment adviser compensation does not raise the presumption that Congress intended to abrogate Rule 23.1 nor has plaintiff presented this Court with any language supporting such a presumption.

In 1970, Section 36(b) was added to the Investment Company Act to "specify that the adviser has a fiduciary duty with respect to compensation for services of other payments paid by the fund . . . to the adviser." S.Rep.No.184, 91st Cong., 1st Sess. (1969), *reprinted in*

[1970] U.S.Code Cong. & Admin.News at 4902. The enactment of Section 36(b),

> is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interests of its shareholders from the directors of such company to the judiciary.

Id. at 4903. This legislative history supports defendants' position that the congressional motivation behind Section 36(b) was to combine forces between the unaffiliated directors and the Federal courts to adequately and equitably supervise the amount of advisory fees. Plaintiff's inference that this supervision can only occur at the sacrifice of Rule 23.1 is unreasonable and unwarranted. It would indeed be inconsistent with the expressed motives of the 1970 Amendments "to have been willing to rely largely upon 'watchdogs' [unaffiliated directors] to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled." *Burks, supra*, 441 U.S. at 485, 99 S.Ct. at 1840.

Judge Lasker's decision in *Blatt* ignored the congressional imperative for independent management of money market funds and mistakenly presumed, in reliance on *Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y.1975) (LPG), that the directors of an investment company are uniformly antagonistic to "an action

against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation." *Id.* at 696. Section 10 of the Investment Company Act which mandates that directors unaffiliated with both the investment advisor and the fund's principal underwriter comprise forty percent of an investment company's board of directors, refutes on its face the presumption of hostility found in both the *Blatt* and *Boyko* decisions. Unless plaintiff is prepared to contest the true "disinterest" of each unaffiliated director, these independent board members will continue to examine with a discerning eye, as Congress intended, the payments of advisory fees. Without diligent observation of Rule 23.1 these directors will be denied an opportunity to fulfill the congressional mandate.

The importance of director involvement in the instant case is underscored in Section 36(b)(2), which provides that director approval of any advisory fees "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). This provision permits the court to scrutinize the directors judgment in approving adviser compensation and to evaluate whether the "deliberations of the directors were a matter of substance or a mere formality." S.Rep.No.184, 91st Cong., 1st Sess. (1969) *reprinted in* [1970] U.S.Code Cong. & Admin.News at 4910. Rule 23.1, which fosters director input, is crucial to the court's determination and despite plaintiff's arguments, it will not be ignored.

3. *Section 16(b)*

Plaintiff's final argument rests on an ill conceived analogy between Section 16(b)[3] of the Securities Exchange

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3 "Section 16(b) authorizes actions on behalf of a corporation to recover short-swing profits realized by corporate insiders as a

Act of 1934, 15 U.S.C. § 78p(b), and Section 36(b). Plaintiff cites cases for the proposition that Rule 23.1 does not apply to Section 16(b) cases, *Dottenheim v. Murchison*, 227 F.2d 737 (5th Cir. 1955), *cert. denied*, 351 U.S. 919, 76 S.Ct. 712, 100 L.Ed. 1451 (1957); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016, 74 S.Ct. 872, 98 L.Ed. 1138 (1954). However, these cases dealt with the contemporaneous ownership requirement of Rule 23.1 and not the demand clause at issue here. Thus, plaintiff's reliance on this case law is misplaced. This crucial distinction destroys plaintiff's suggested analogy between Section 16(b) and Section 36(b).

I am convinced that Rule 23.1 and Section 36(b) can and should co-exist compatibly. Plaintiff's arguments do not persuade me otherwise. Plaintiff's failure to make a Rule 23.1 demand on the fund directors is grounds for dismissal of the complaint unless Mr. Fox's failure to make such a demand may be excused by some extraordinary circumstances.

Plaintiff's complaint states at paragraph 14:

> No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action for the reason that no such demand is required under § 36(b) of the Act. Moreover, all of the directors are beholden to R&T for their positions and have participated in the wrongs complained of in this action. Their initiation of an action like the instant one would place the prosecution of this action in the hands of persons hostile to its success.

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result of their purchases and sales of the corporation's equity securities." *Markowitz, supra*, 90 F.R.D. at 551.

This averment, besides being inconsistent with plaintiff's argument that the directors cannot maintain their own action, presents no adequate grounds for disobedience with Rule 23.1. The contention that all the Fund directors are involved in the wrongdoing and necessarily hostile to plaintiff's claim is unfounded. First of all, this presumption is contrary to the congressional entrustment of surveillance responsibilities to the unaffiliated directors discussed *supra*. *Burks, supra*, 441 U.S. at 486, 99 S.Ct. at 1841. Secondly, plaintiff's only proof of the potential hostility of the Fund directors to the instant case is found in the Fund's proxy statement dated September 4, 1981. This statement, issued four months after plaintiff filed his complaint discusses the instant litigation: "The Manager and the Corporation believe that the advisory fees paid by the Corporation have not been and are not excessive, and the Manager and the Corporation intend to deny and contest the material allegations of the complaint." at p. 10. This post-complaint hindsight cannot excuse Mr. Fox's failure to make a demand on the directors before filing his complaint.

Plaintiff has presented no justification for his noncompliance with Rule 23.1. Plaintiff alternatively requests that if this Court rules unfavorably, leave be granted to file an amended complaint. The rule in this Circuit is that leave to file amended complaints is usually freely granted absent prejudice to the parties. *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 856 (2d Cir. 1981). In the instant case, prejudice to the directors would result from plaintiff's dilatory amendment. One of the purposes of Rule 23.1 is to allow the directors to respond to plaintiff's claim prior to the initiation of a lawsuit. Allowing plaintiff to now file an amended complaint

would make a mockery of the demand requirement. *See Shlensky v. Dorsey*, 574 F.2d 131, 141 (3d Cir. 1978); *Weiss v. Temporary Investment Fund, Inc.*, 520 F.Supp. 1098 (D.C.Del.1981).

Thus, defendants' motion to dismiss is granted and plaintiff is denied leave to file an amended complaint.

SO ORDERED.

Decision of the Court of Appeals

No. 74, Docket 82-7296.

United States Court of Appeals,
Second Circuit.

Argued September 16, 1982.
Decided October 26, 1982.

MARTIN FOX,

Plaintiff-Appellant,

—v.—

REICH & TANG, INC. and
DAILY INCOME FUND, INC.,

Defendants-Appellees.

Shareholder appealed from dismissal by the United States District Court for the Southern District of New York, Kevin Thomas Duffy, J., 94 F.R.D. 94, of shareholder's action to recover allegedly excessive fees paid by investment company to its adviser. The Court of Appeals, Irving R. Kaufman, Circuit Judge, held that: (1) investment company did not possess right of action under section of Investment Company Act of 1940 that provides right of action to recover excessive fees by Securities and Exchange Commission or by security holder, and (2) demand requirement of Federal Rule of Civil Procedure

governing derivative actions was inapplicable to shareholder's suit.

Reversed and remanded.

Richard M. Meyer, New York City (Milberg, Weiss, Bershad & Specthrie, New York City, of counsel), for plaintiff-appellant.

Daniel A. Pollack, New York City (Pollack & Kaminsky, Frederick P. Schaffer, New York City, of counsel), for defendant-appellee Daily Income Fund, Inc.

Seward & Kissel, New York City (Anthony R. Mansfield, New York City, of counsel), for defendant-appellee Reich & Tang, Inc.

Before FEINBERG, *Chief Judge*, and
FRIENDLY and KAUFMAN, *Circuit Judges*.

IRVING R. KAUFMAN, *Circuit Judge:*

This case presents an issue of first impression in this Circuit. The question before us is whether, in a shareholder action brought pursuant to § 36(b) of the Investment Company Act of 1940 to recover allegedly excessive fees paid by an investment company to its adviser,[1] the

1 Section 36(b) imposes upon the investment adviser of a registered investment company "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). It creates a cause of action for breach of that duty, *id.*, and specifically limits "[a]ny award of damages . . . to the actual damages resulting from the breach of fiduciary duty[,] . . . in no event exceed[ing] the

shareholder plaintiff is required to plead that a "demand" was made on the company's board of directors prior to filing of the complaint.[2] At first blush, resolution of this question would seem to require merely clarification of a technical pleading rule. As our discussion makes clear, however, analysis of the issue is not uncomplicated, nor is our conclusion without important ramifications for suits brought pursuant to § 36(b).

I

Because this case comes to us from a dismissal at the pleading stage, the factual record is sparse. Martin Fox, a shareholder of Daily Income Fund, Inc. ("the Fund"), brought this action on behalf of the Fund to recover allegedly excessive fees paid by the Fund to its investment adviser, Reich & Tang, Inc. ("R & T"). The Fund, an open-end investment company of the type commonly referred to as a "money-market fund," pursues as its basic business strategy the goal of achieving high current income levels while preserving capital. To this end, it invests in a portfolio of short-term money market instruments, principally United States government and federal agency obligations, obligations of major banks, and prime commercial paper. The Fund experienced a dramatic surge in its assets, in a relatively short period of

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amount of compensation or payments received from [the] investment company. . . ." The legislative history reveals that Congress created this somewhat particularized fiduciary duty with specific reference to the recurring problem of payment of excessive adviser and management fees, *e.g.*, S.Rep. No. 184, 91st Cong., 1st Sess. 5-6 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News 4897, 4901-02.

2 This pleading requirement in the federal courts is embodied in Federal Rule of Civil Procedure 23.1, the text of which is set out at note 6.

time. As of June 30, 1978, the Fund's net assets were approximately $75 million. Less than three years later, on April 15, 1981, they had reached a level of $775,000,000. Precisely this sort of "dramatic growth"[3] impelled enactment of the 1970 amendments to the Investment Company Act of 1940, and, in particular, § 36(b), which created a cause of action for return of excessive adviser fees. Because fees are usually calculated as a percentage of assets, substantial portfolio appreciation brings with it the risk of unduly high adviser compensation. *See* S.Rep. No. 184, 91st Cong., 1st Sess. 6 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4902; *see also* J. Barnard, Jr., *Reciprocal Business, Sales Charges and Management Fees,* in 1966 Fed. B.A. Conference on Mutual Funds 127-29.

Despite this substantial increase in Fund assets, no adjustment was made in the rate at which R & T was to be paid for investment advice and other management services rendered. R & T's fee was originally set one-half of one percent of the Fund's net assets, and it remains fixed at that rate. Consequently, yearly payments by the Fund to its adviser increased from approximately $375,000 in

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3 S.Rep. No. 184, 91st Cong., 1st Sess. 3 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4899. After passage of the Investment Company Act of 1940, the industry experienced a period of relative stability. During the first year 436 companies registered, pursuant to the Act. At the end of fiscal year 1959, the number of companies had increased to only 453 with aggregate assets of about $20,000,000,000. By 1966, just seven years later, 727 companies were registered, representing assets of nearly $50 billion. 1966 SEC Ann.Rep. 100. Not surprisingly, that same year Congress requested the Securities and Exchange Commission to investigate this matter. The SEC's findings, and recommendations for legislative action are contained in *Report on the Public Policy Implications of Investment Company Growth, reprinted in* H.R.Rep. No. 2337, 89th Cong., 2d Sess. (1966) *("1966 SEC Report").*

1978, to a projected $3,875,000 in 1981. During the fiscal year ending June 30, 1980, R & T received more than $2,000,000 in management fees from the Fund. It is this extraordinary leap in fees of which Fox complains.

Fox's complaint alleged that management of the assets of a money market fund requires no detailed analysis of industries (or of large individual industrial concerns), nor the retention of a large staff of highly paid, sophisticated securities analysts. Essentially, he claimed that investment decisions are more or less routine, concentrated as they are in the relatively limited realm of "turning over" money market investments with a small number of institutions. In short, Fox alleged that R & T was continuing to provide the services it had always rendered, for what had become an exorbitant amount of money.

Rather than approach the Fund's directors with his grievance, Fox chose to allege in his complaint that no "demand" is required under § 36(b).[4] In response, the

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4 Fox's complaint asserted, in addition to this legal conclusion, that "all of the [Fund's] directors are beholden to R & T for their positions and have participated in the wrongs complained of in this action. Their initiation of an action like the instant one would place the prosecution of this action in the hands of persons hostile to its success." Apparently by way of response, the Fund notes that a majority of its Board of Directors, three of five, are "disinterested directors." We need not deal with the effect of these statements. Some courts have held demand will be excused when a plaintiff shows that a majority of the investment company's directors possess an interest in the subject matter of the lawsuit sufficient to conclude that it would have been futile to ask for board action. *E.g.*, *Markowitz v. Brody*, 90 F.R.D. 542, 556 (S.D.N.Y. 1981). Yet, the mere presence of a majority of directors not directly employed by the adviser may not automatically result in the conclusion that a demand will be required. *See Lewis v. Curtis*, 671 F.2d 779, 785-86 (3d Cir. 1982). Because we agree with Fox that a § 36(b) action is exempt from the director demand requirement of Rule 23.1, we do not pass on the excuse issue.

Fund (later joined by R & T) moved to dismiss for failure to comply with Rule 23.1. After noting that the issue had resulted in a split among the district courts in this Circuit,[5] Judge Duffy concluded that a Rule 23.1 demand was required in a § 36(b) suit, and dismissed the complaint. Fox appealed. For the reasons stated below, we disagree with the district court's conclusion, 94 F.R.D. 94, and reverse.

II

We begin by noting that the Rule 23.1 demand requirement applies only when a corporation or association has "failed to enforce a right which may properly be asserted by it."[6] We agree with Fox that the rule applies only when

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5 Indeed, the conflict between previous district court cases could not be more stark. In *Markowitz v. Brody, supra,* 90 F.R.D. at 554-55, Judge Ward concluded that Rule 23.1 applies to § 36(b) shareholder suits. *Accord, Gartenberg v. Merrill Lynch Asset Management, Inc.,* 91 F.R.D. 524, 526-28 (S.D.N.Y.1981). In direct contrast, Judge Lasker has stated: "a demand on the directors of the fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital, Inc.,* 528 F.Supp. 1152, 1155 (S.D.N.Y.1982) (dictum). *Cf. Boyko v. Reserve Fund, Inc.,* 68 F.R.D. 692, 696 (S.D.N.Y.1975) (Gagliardi, J.) (when at least one affiliated or interested director on mutual fund board, futility of demand will be presumed, and, therefore, Rule 23.1 will be satisfied).

6 Fed.R.Civ.P. 23.1 provides, in its entirety:

> Derivative Actions by Shareholders
>
> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer

the specified entity has an opportunity to "assert," in a court, the same action under the same rule of law on which the shareholder plaintiff relies. Thus, if the Fund may not sue pursuant to § 36(b), no demand upon its board of directors will be required. In rejecting the Fund's argument that even if it cannot bring an action under § 36(b), a demand must be made upon its directors to utilize other, informal means to "enforce its right" to return of excessive adviser fees, Brief of Defendant-Appellee Daily Income Fund, Inc. at 5-6,[7] we announce no

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jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

7 As indicated, we disagree that availability of informal methods of attempting to recoup excessive adviser fees is sufficient to trigger the demand requirement of Rule 23.1. Moreover, we find the examples given by the Fund—negotiating with the Adviser to obtain a refund, and terminating the contract, Brief for Defendant-Appellee Daily Income Fund, Inc. at 5-6—not persuasive. Negotiations may well fail, and termination of the contract, although perhaps depriving the adviser of future business, may not effect the remedy sought by the shareholder plaintiff, which is the return of excessive fees. Additionally, "a mutual fund cannot, as a practical matter sever its relationship with [its] adviser." S.Rep. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4901. Moreover, given the directors' past relationship with the adviser in approving the contract in the first place, 15 U.S.C. § 80a-15(c), the

new rule of law. As long ago as the beginning of this century, the Supreme Court construed Equity Rule 94, 104 U.S. ix (1882), the precursor of Rule 23.1, and determined that its nearly identical language[8] referred to "a suit founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff." *Delaware & Hudson Co. v. Albany & Susq. R.R.*, 213 U.S. 435, 447, 29 S.Ct. 540, 543, 53 L.Ed. 862 (1909); *see also Ross v. Bernhard,* 396 U.S. 531, 534-35, 90 S.Ct. 733, 735-736, 24 L.Ed.2d 729 (1970).

Accordingly, we turn initially to the question whether an investment company can bring an action under § 36(b) of the Investment Company Act of 1940.

A

Our starting point, as in every case involving construction of a statute, is examination of the language utilized

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likelihood that negotiations will prove effective is highly speculative. *See Blatt v. Dean Witter Reynolds Intercapital, Inc., supra,* 528 F.Supp. at 1156 (dictum). In reaching this conclusion, we do not ignore the salutary purpose served by requiring complaining shareholders to first "activate intracorporate remedies," *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D.Ill.1981). Rather we conclude that a demand will not be mandated unless, should intracorporate efforts prove insufficient, the corporation itself may bring suit. *Id.* (quoting *Hawes v. Oakland,* 104 U.S. 450, 460-61, 26 L.Ed. 827 (1882)).

8 Equity Rule 94 provided, in relevant part:

> Every bill brought by one or more stockholders in a corporation against the corporation and other parties *founded upon the rights which may properly be asserted by the corporation* . . . must . . . set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors . . . .

Eq.R. 94, 104 U.S. ix (1882) (emphasis added).

by Congress. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 197, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976). The second sentence of § 36(b) is quite clear that an action may be brought under that subsection only "by the [Securities and Exchange] Commission, or by a security holder of [a] registered investment company on behalf of such company."[9] No action by the investment company is

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9 The full text of § 36(b) is as follows:

15 U.S.C. § 80a-35. Breach of fiduciary duty

* * * * * *

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or

authorized. When Congress has provided specific and elaborate enforcement provisions, and entrusted their use to particular parties, we will not lightly assume an unexpressed intention to create additional ones. *See Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n,* 453 U.S. 1, 13-15, 101 S.Ct. 2615, 2622-2624, 69 L.Ed.2d 435 (1981).

Appellee points to the words "on behalf of such company," and argues they demonstrate that the right of the shareholder created by § 36(b) is derivative, and therefore the director demand requirement of Rule 23.1 applies, as it does to other "derivative" actions in the federal courts.

The words "on behalf of" do not create by implication a statutory right of the company itself to sue, from which the stockholders' right may be said to be "derivative."

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payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

These words, which apply as much to the Securities and Exchange Commission as to a private security holder, signify only that either party so entitled to bring an action under § 36(b) must do so to seek return of excessive management fees to the company treasury and not to individual or governmental coffers. The action is not, strictly speaking, "derivative" in the sense of deriving from a right properly asserted by the corporation, but rather constitutes individual security holders as "private attorneys general" to assist in the enforcement of a duty imposed by the statute on investment advisers.

We recognize that the one Court of Appeals to have considered the question reached a different conclusion. *Grossman v. Johnson,* 674 F.2d 115 (1st Cir.), *cert. denied,* ___ U.S. _____, 103 S.Ct. 85, 73 L.Ed.2d— (1982). In rejecting the argument that because § 36(b) explicitly provides for, it therefore only permits, suit by the SEC or a security holder, the First Circuit stated:

> We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees from an investment adviser, would be precluded from suing under section 36(b).

Id. at 120. Equally cogent is our belief that this situation was regarded as so remote or unlikely that the legislature chose not to provide for it, and was wary of permitting the Fund to control the suit, *see Burks v. Lasker,* 441 U.S. 471, 483-84, 99 S.Ct. 1831, 1839-1840, 60 L.Ed.2d 404 (1979). Moreover, the *Grossman* court offers scant support for its conclusion that the Fund may sue. It refers, first, to the "on behalf of" language in the statute. We have already indicated the meaning we attach to that phrase. Similarly, we are unpersuaded by the argument that "Congress could well have believed that,

though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action[,] . . . it was unnecessary to say with particularity that the company also did." *Id.* This seems totally inconsistent with what we would expect Congress to have done. If Congress had intended to provide the company with a cause of action, it would have passed a statute saying so, in which case the derivative right of a shareholder to initiate suit would have followed automatically. A mere statement of what Congress "could have believed" seems to us not enough. Congress has not expressed, anywhere at all, the policy appellee would have us adopt.

Moreover, as the First Circuit itself notes, § 36(b)(3) "directly forbids" an action against any person "other than the recipient of . . . compensation or payments [for adviser services]." Yet, the opinion relies on the proceeding in that case having been brought against "forbidden" defendants (the "disinterested" directors and the Fund itself) as support for its conclusion that a § 36(b) suit is a typical derivative suit. The idea, apparently, is that Grossman was operating under the assumption that a § 36(b) action is the standard derivative action, in which the complaining shareholder would join the company and its directors, "in the ordinary fashion," after the corporation had declined to initiate the suit as a plaintiff. *See* H. Henn, *Handbook of the Law of Corporations and Other Business Enterprises* § 358 at 750 (2d ed. 1970). It is difficult to understand how a defect in a pleading—or a misreading of § 36(b)—can take precedence over the clear dictates of a statute.

The language of a statute controls when sufficiently clear in its context. *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 201, 96 S.Ct. at 1384. Nevertheless, mindful

of our obligation to supplement application of rules of statutory construction by searching for "persuasive evidence of a contrary legislative intent," *Transamerica Mortgage Advisors, Inc. v. Lewis, supra,* 444 U.S. 11 at 21, 100 S.Ct. 242 at 247, 62 L.Ed.2d 146 we move now to an examination of the legislative history of § 36(b).

B

Prior to enactment of the Investment Company Act of 1940, open-end investment companies,[10] or mutual funds, played a minor role in the world of finance. In 1940, investment companies held assets of approximately $2.1 billion; of this sum, mutual funds accounted for $450 million. *1966 SEC Report 2.* The 1940 Act was directed at the most flagrant self-dealing and other abuses within the investment company industry. *See United States v. Deutsch,* 451 F.2d 98, 108 (2d Cir. 1971), *cert. denied,* 404 U.S. 1019, 92 S.Ct. 682, 30 L.Ed.2d 667 (1972). It prohibits, for example, most transactions between investment companies and their advisers. 15 U.S.C. § 80a-17. Generally, the Act requires at least forty percent of a fund's board of directors to be "unaffiliated" with the adviser, and it mandates that payment for management and other investment advice be the subject of a contract between the fund and the adviser which has received both shareholder and director approval, 15 U.S.C. § 80a-15(a), (c). Moreover, a duty is imposed on the directors of a fund to evaluate the terms of the adviser contract. 15 U.S.C. 80a-15(c).

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10 An "open-end" company is one which continually offers shares for sale and will redeem outstanding shares at their proportionate net asset value. 15 U.S.C. § 80a-5(a)(1).

The 1940 Act proved most successful in controlling the serious problems covered by its broad brush approach. Indeed, an ironic measure of its success has been the public's growing confidence in the investment company industry, which led to a period of extraordinary growth in the number of investors and in net asset levels of the funds. In turn, this expansion created a specific and largely unforeseen problem. Because adviser fees are usually calculated at a percentage of a fund's net assets, and vary in proportion as portfolio value goes up or down, a period of sustained industry success would—and did—yield substantially increased fees. But the Act "did not provide any mechanism by which the fairness of management contracts could be tested in court." S.Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4901.

What the drafters of the 1940 Act *did* foresee, in a general way, was the possibility that the future success of the industry might entail the need for statutory change. As a result, a section of the original statute provided (and still states) that the SEC may study the ramifications of "any substantial further increase in size of investment companies . . . involving the protection of investors or the public interest," and present recommendations for legislative change. 15 U.S.C. § 80a-14(b). Accordingly, in 1958, the Commission authorized the securities research unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to study investment companies and report its findings. The Wharton Report identified the salient issues, but made no proposals. Subsequently, the Commission undertook further research, and presented the results and recommendations for detailed amending legislation in its ***Report on the***

Public Policy Implications of Investment Company Growth, transmitted to Congress in 1966.

The *1966 SEC Report* reiterated the Wharton unit's findings. It concluded that mangement fees tended to be fixed at the traditional level of one-half of one percent of the fund's net assets. It noted that they markedly exceeded fees charged by investment advisers to other institutional clients and the cost of management to those funds which manage themselves. Moreover, no evidence existed to demonstrate a willingness on the part of the advisers to provide services at a "reasonable" rate, not necessarily a percentage of assets. The Report further stated that the 1940 Act was not equipped to deal with this emerging problem, and that shareholder suits, although occasionally forcing settlements, basically had been ineffective. *1966 SEC Report* 84-149. To deal with this issue, the SEC recommended amending the Act to require that mangement fees be "reasonable." Reasonableness was to be determined by reference to various criteria, including the fees paid for similar services by like institutions, the nature and quality of services rendered, and any other factors determined to be appropriate in the public interest. The SEC was to have an enforcement action available to it (as in fact it does under present § 36(b)), and would also possess the right to intervene in private shareholder suits. *Id.* at 143-47. Nowhere does the Report mention an action brought by the investment company itself.

The standard of "reasonableness" proposed in the *1966 SEC Report* was contained in the first bills considered by Congress, H.R.9510, 90th Cong., 1st Sess. § 8(d) (1967) and S.1659, 90th Cong., 1st Sess. § 8(d) (1967). Not surprisingly, it was met by vigorous industry opposi-

tion, *see generally Hearings on S.1659 Before the Senate Comm. on Baking and Currency*, 90th Cong., 1st Sess., pt. 1, at 191-201 ("*1967 Senate Hearings*"); *Investment Company Act Amendments of 1967: Hearings on H.R.9510, H.R.9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., ser. 90-21, pt. 1, at 237-43 (1967) (statement of John R. Haire, chairman-elect, Investment Company Institute), and neither bill passed. The industry claimed fees were already reasonable, the legislation would encourage "strike" suits, and the SEC would be empowered to regulate a competitive industry. *1967 Senate Hearings* at 191-92, 202. In one sense, of course, the relative merits of each side of this debate are irrelevant. The ultimate passage of § 36(b) settled the issue and expressed the legislative conclusion that imposing a "fiduciary duty" and leaving its exegesis to the judiciary[11] provided the best solution. This decision represented the compromise reached by industry repre-

11 *E.g.*, 15 U.S.C. § 80a-35(b)(2); *see 1967 Senate Hearings* at 1016:

> It is for Congress to decide in each case just what mix of administrative and judicial participation is best adapted to the problem in hand. One end of the spectrum provides more in administrative expertise and uniformity, the other more in those qualities of restraint, freedom from bureaucratic rigidity, open-mindedness and good sense that judges like to believe are special attributes of courts.
>
> (Statement of Judge Henry J. Friendly)

The quoted language goes to the question whether case-by-case judicial evaluation of allegations of excessive adviser fees, on the one hand, or an administrative procedure which would also weigh industry-wide factors, on the other, is best suited to adjudication of shareholder complaints. Congress apparently believed, along with my brother Friendly, that courts possessed sufficient good qualities to make them appropriate forums in which § 36(b) complaints might be heard.

sentatives and the SEC. *See Hearings on H.R.11995, S.2224, H.R.13754, H.R.14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce,* 91st Cong., 1st Sess., ser. 91-33, pt. 1, at 138 (1969) ("*1969 House Hearings*"). On the other hand, that the focus of legislative inquiry, from the introduction of the first bills through a period of several years until enactment, remained fixed on this question, is of special significance for our purpose. The normal conclusion to be drawn from intensive—and exclusive—Congressional scrutiny of a particular subject is that Congress did not concern itself with others. Put differently, if the voluminous legislative history of § 36(b) and its unsuccessful predecessors persuades us that Congress's first order of business was now to make shareholder suits (and SEC enforcement actions) effective, rather than whether it might also be useful to sanction suit by a fund, we would be hard-pressed to conclude that Congress intended to empower the courts to permit a fund to sue.

It is obviously difficult, under the best of circumstances, to prove a negative. Because the extensive legislative history of § 36(b) neither approves nor disapproves suits brought directly by mutual funds, it cannot be shown to a certainty (and perhaps never to the satisfaction of those disposed to believe otherwise) that Congress foreclosed their use of the section. What *can* be shown, in this instance, is that the Congressional approach to a specific problem—excessive adviser fees—consisted of, first, identifying the source of that problem; next, determining why the 1940 Act, in other respects effective, had been and would continue to be incapable of remedying it; and finally, amending the relevant portion of the Act. If, therefore, the source of the problem is inconsistent with a

corporate right of action as a solution, we can say with confidence that Congress never intended to create one. Moreover, if the flaw in the 1940 Act was unrelated to the unavailability of a suit by the fund, our conclusion becomes virtually certain, since we know that the statutory lacuna was filled by a provision conspicuous for its failure to name the fund as a potential plaintiff.

Several years of careful study indicated that the problem derived from the peculiar nature of the mutual fund industry (seen in light of its rapid growth):

> Mutual funds, with rare exceptions, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. These fees are usually calculated at a percentage of the funds' net assets and fluctuate with the value of the funds' portfolio.
>
> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the

mutual fund industry in the same manner as they do in other sectors of the American economy.

* * * * *

It is noted . . . that problems arise due to the economies of scale attributable to the dramatic growth of the mutual fund industry. In some instances these economies of scale have not been shared with investors. Recently there has been a desirable tendency on the part of some fund managers to reduce their effective charges as the fund grows in size. Accordingly, the best industry practice will provide a guide.

S.Rep. No. 184, 91st Cong., 1st Sess. 5-6 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4901-02; *see also 1966 SEC Report* 131; H.R.Rep. No. 1382, 91st Cong., 2d Sess. 7 (1970); *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976).

Additionally, the requirement that a percentage of the directors of the investment company be "independent" of the adviser and underwriter, 15 U.S.C. § 80a-10, and that they annually approve the adviser contract, 15 U.S.C. § 80a-15, cannot seriously be expected to induce arm's-length bargaining. As the SEC long ago recognized, any so-called independent directors would "obviously have to be satisfactory to the dominating stockholders who are in a position to continue to elect a responsive board." *Petroleum & Trading Corp.*, 11 S.E.C. 389, 393 (1942); *see 1969 House Hearings*, ser. 90-22 at 696-97 (testimony of SEC Chairman Manuel F. Cohen).

In sum, the root of the excessive adviser fee problem is basically incompatible with a corporate right of action as an effective solution. We believe the Senate Committee on Banking and Currency (referring to the bill eventually passed) had in mind exactly the plaintiffs it named and no others when it stated: "[Y]our committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of [adviser] fees, there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." S.Rep. No. 184, 91st Cong., 1st Sess. 1 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad.News at 4898. Neither the parties' briefs nor our own research has disclosed any indication in the comprehensive legislative history of § 36(b) that suits by directors themselves were to be expected or encouraged. Although we agree with Judge Duffy that Congress intended the directors would perform a "watchdog" function, *see also Burks v. Lasker, supra,* 441 U.S. at 484, 99 S.Ct. at 1840; *Boyko v. Reserve Fund, Inc., supra,* 68 F.R.D. at 695-96 n.2, it defies logic to conclude their contemplated role included suing their advisers.

Moreover, the 1940 Act was not deficient or ineffective because a fund could not use it. By the time consideration of the 1970 Amendments was at hand, it had become clear that shareholders were hard pressed to prove a "gross abuse of trust," the standard of old § 36. *Saxe v. Brady,* 40 Del.Ch. 474, 184 A.2d 602 (1962) (Seitz, Ch.), decided under traditional corporate law concepts, provided the model adhered to by federal courts in suits alleging excessive management fees. *See Kurach v. Weissman,* 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970). In *Saxe,* mutual fund shareholders challenged adviser fees amounting to one-half of one percent of net assets. The

adviser contract had been approved almost unanimously by the shareholders. Chancellor Seitz (now Chief Judge of the Third Circuit Court of Appeals) concluded that the adviser fee level must be evaluated according to the usual legal rules applicable to shareholder ratification cases:

> When the stockholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given.

Saxe v. Brady, supra, 40 Del.Ch. at 486, 184 A.2d at 610. In concluding that plaintiffs must show "actual waste," or a fee level so high as to be "unconscionable," *id.*, the Chancellor noted that a 0.5% adviser fee rate was common and that the shareholders had approved the adviser contract virtually unanimously. *Id.* at 489, 184 A.2d at 611-12. Since these determinative factors were inevitably present, showing "actual waste" and overcoming a presumption of "sound business judgment" was well nigh impossible. *Kurach v. Weissman, supra*, 49 F.R.D. at 305-06; *Goodman v. Von Der Heyde*, [1969-1970 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 92,541 (S.D.N.Y.1969); *Lessac v. Television-Elecs. Fund*, [1967-1969 Transfer Binder] Fed.Sec.L.Rep. ¶ 92,305 (S.D.N.Y.1968); *see Rosenfeld v. Black*, 445 F.2d 1337, 1345-46 (2d Cir.1971). Recognizing that shareholder plaintiffs had difficulty sustaining their burdens, Congress changed only the standard of duty. *Cf. Burks v. Lasker, supra*, 441 U.S. at 483-84, 99 S.Ct. at 1839-1840 (1979).

Despite the long odds, shareholders did sue for return of allegedly excessive fees. Starting in 1959, over fifty suits were instituted under common law principles and pursuant to the 1940 Act. *1966 SEC Report* 132. What happened is instructive. Advisers were sometimes willing to settle, because even *Saxe* left open the possibility that the point might be reached at which "profits . . . outstripp[ed] any reasonable relationship to expenses and effort even in a legal sense." 40 Del.Ch. at 498, 184 A.2d at 616-17. Given the substantial sums at stake, this willingness is not surprising. For precisely the opposite reason—that is, the slim likelihood of success on the merits—courts felt constrained to approve settlements, even when the terms were something less than desirable. *E.g., Jurach v. Weissman, supra,* 49 F.R.D. at 305. This confluence of inconsistent, but complementary, motives resulted in reduction of adviser fees in individual cases, but the effect on the industry as a whole was insignificant. In 1967, SEC Chairman Manuel Cohen noted that "[t]he median advisory fee paid by the 59 externally managed mutual funds with net assets of $100 million or more in fiscal years ending in 1966 was still 0.48 percent, down only 0.02 percent from the traditional 0.50 percent rate." *1967 Senate Hearings*, pt. 1, at 14-15. Obviously, the pressure to settle was analytically unrelated to the identity of the plaintiff.

Our retracing of the analysis employed by Congress, and of its extensive documentation, persuades us that an investment company was not intended to possess a right of action under § 36(b). The relationship of a Fund to its adviser makes it a part of the problem in a way that precludes it from being part of the solution, at least at the

litigation stage. The provision for evaluation of the adviser contract, 15 U.S.C. § 80a-15(c), and the general tightening of the powers of disinterested directors, *e.g.*, 15 U.S.C. §§ 80a-2(a)(19); 80a-10(a); 80a-15(c), provide for "an independent check on management . . . and the representation of shareholder interests in investment company affairs," S.Rep. No. 184, 91st Cong., 1st Sess. 32 (1969), *reprinted in* 1970 U.S.Code Cong. & Ad.News at 4927. We take this language to be nothing more nor less than a declaration by Congress that it was imposing duties on the directors to run the ongoing business of the Fund in a responsible manner, and with due regard for investors. *Cf. United States v. National Ass'n of Sec. Dealers*, 422 U.S. 694, 705 n. 13, 95 S.Ct., 2427, 2436 n. 13, 45 L.Ed.2d 486 (1975)(1940 Act concerned with imposing controls on "internal management [and] practices of investment companies"). These functions and duties having proved ineffective in a particular case, at least in the eyes of the complaining shareholder plaintiff, the issue for Congressional scrutiny was how to particularize the already existing statute to make judicial relief a genuine possibility. Experience with shareholder suits had demonstrated that the *Saxe* standard, drawn from pre-existing corporate law principles but applied to the investment company industry, was useless. The fiduciary duty standard was imposed, and courts were empowered to view "all the circumstances," 15 U.S.C. § 80a-35(b)(2). The extensive number of suits brought under the earlier, less favorable law suggested that shareholders would move with alacrity pursuant to the new one. Given the nature of the problem and reasons for the 1940 Act's failure to remedy it, creating a corporate right of action

would have made little sense and we conclude Congress never intended to do so.[12]

III

We have not as yet considered the applicability of Rule 23.1 head-on. Instead, we posed the analytically precedent question, whether a Fund may use § 36(b), and thereby trigger the rule. Our answer, that Rule 23.1 does not apply because the Fund has no right of action, renders superfluous any extensive discussion of the policy behind requiring demand. Nonetheless, because we believe neither policy nor logic compels application of the demand requirement to actions for return of excessive adviser fees, we briefly discuss the distinctiveness of § 36(b).

Unlike the board in the common variety of derivative suit, the directors have no power to terminate a § 36(b) action. Other provisions of the Investment Company Act. *e.g.*, 15 U.S.C. § 80a-13(a)(3), governed by state rules to the extent they are not inconsistent with federal law, leave unanswered the question whether independent directors of an investment company may terminate suit. ***Burks v. Lasker, supra***, 441 U.S. at 483-86, 99 S.Ct. at 1839-1841. "[W]hen Congress . . . intend[ed] to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . , added to the act in 1970, performs precisely this function . . . ." *Id.* at 484, 99 S.Ct. at 1840 (citation omitted). Since directors cannot cut off a suit

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12 We agree with the First Circuit, ***Grossman v. Johnson, supra***, 674 F.2d at 121, that debate over the legislative history "end[s] in a draw," but we proceed under a different assumption, that § 36(b) does not permit an action by the investment company, and reach the opposite conclusion that Congress intended no demand requirement would apply.

and § 36(b) does not authorize them to institute one, and because shareholder plaintiffs are necessarily challenging fees the directors evaluated and approved, 15 U.S.C. § 80a-15; *see Rosenfeld v. Black, supra*, 445 F.2d at 1345, the traditional reason for the demand requirement simply does not apply. *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 171-72 (1976).[13]

Moreover, although requiring demand normally imposes only minor hardship on the complaining shareholders, in a § 36(b) suit the consequences can be severe. Section 36(b) expressly limits recovery to excessive fees paid up to one year prior to the commencement of suit. 15 U.S.C. § 80a-35(b)(3). The demand requirement implies a reasonable time in which directors may analyze the issues and determine whether they believe the company has a grievance. The delay caused by this process would, in many cases,[14] have the untoward result of precluding

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13 One court, analogizing *Burks v. Lasker*, concluded that the question whether a board of directors is sufficiently "interested" in the challenged transaction to excuse demand shall be resolved by reference to "the same factors used to determine whether a court should defer to the board's decision not to pursue the action" *Lewis v. Curtis, supra*, 671 F.2d at 785. Under this view, the termination and excuse issues are functions of the same indicia of "interestedness." *Burks* may be regarded as recognizing the Congressional determination that directors in § 36(b) actions are *never* sufficiently disinterested to permit them to terminate suit, 441 U.S. at 484, 99 S.Ct. at 1840. Viewing these two principles in tandem, it is possible to infer that Congress also believed directors would always be so "interested" that demand would inevitably be "excused." This is but another way of saying Congress intended that § 36(b) suits would be *exempt* from Rule 23.1.

14 At oral argument, Fox's counsel referred to the case where the fund may have awarded a substantial one-time payment for allegedly remarkable services. No doubt other examples could be cited.

full recovery of excessive fees while the directors determined whether they had acted against the interests of the shareholders in approving the contract initially. We do not believe Congress was unaware of this pitfall.

IV

In a different contest, Justice Jackson eloquently described the origin and rationale of the derivative suit:

> Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights, but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy, born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548, 69 S.Ct. 1221, 1226, 93 L.Ed. 1528 (1949). In holding that a Rule 23.1 demand will not be required in a shareholder suit brought pursuant to § 36(b) of the Investment Company Act, we do not ignore the appropriateness, in the typical derivative suit alleging corporate wrongdoing, of first asking the corporation to "vindicate" what are, after

all, "its own rights." We conclude, however, that in the unique context of a § 36(b) lawsuit, the shareholder need not afford the fund an opportunity to vindicate its rights because such a requirement would be an empty, unfruitful and dilatory exercise.

The judgment of the district court is reversed and the case is remanded.

Decision of the Court of Appeals for the First Circuit in *Grossman* v. *Johnson*

No. 81-1348.

United States Court of Appeals,
First Circuit.

Argued Nov. 5, 1981.
Decided March 29, 1982.

STANLEY M. GROSSMAN,

Plaintiff-Appellant,

—v.—

EDWARD C. JOHNSON, 3rd, et al.,

Defendants-Appellees.

Shareholder brought derivative action on behalf of investment fund. The United States District Court for the District of Massachusetts, Joseph L. Tauro, J., dismissed the suit, 89 F.R.D. 656, and plaintiff appealed. The Court of Appeals, Davis, Judge, sitting by designation, held that: (1) in adding amendment to Investment Company Act to prescribe separate statutory claim for excessive advisory fees to investment adviser, Congress neither repealed nor limited demand provision of rule, under which complaint to enforce right of corporation or unincorporated association must allege with particularity efforts if any made by plaintiff to obtain action he desires from directors or comparable authority and, if necessary,

from shareholders or members, and reasons for failure to obtain such action or for not making the effort; (2) where shareholder claims to be excused from compliance with such rule requirement, proper excuse of control or domination calls for particularized allegations and specific facts, and mere "participation" or "acquiescence" by directors in level of challenged advisory fees is insufficient excuse where corporate activity is normal one of setting and paying advisory fees, and allegation that directors had already announced firm opposition to suit was equally unavailable where disinterested directors' position did not preclude their first consideration of plaintiff's demand; and (3) on claim of failure to recapture excessive underwriting commissions, discounts and spreads paid by fund on its purchases of securities, shareholder's allegations of excuse for failing to make demand before bringing suit, i.e., that directors all had conflict of interest, was insufficient.

Affirmed.

Richard M. Meyer, Washington, D.C., with whom Avram G. Hammer, Boston, Mass., and Milberg, Weiss, Bershad & Specthrie, New York City, were on brief, for appellant.

James S. Dittmar, Boston, Mass., with whom Berman, Dittmar & Engel, P. C., Boston, Mass., was on brief, for appellees Edward C. Johnson, 3d, et al.

E. Milton Farley, III, Richmond, Va., with whom Sumner H. Babcock, E. Susan Garsh, Bingham, Dana & Gould, Boston, Mass., John W. Riely, Joseph C. Kearfott

and Hunton & Williams, Richmond, Va., were on brief, for appellees Dwight L. Allison, Jr., et al.

Jerome P. Facher, Boston, Mass., with whom Harry T. Daniels, James R. Gomes, Hale & Dorr, Peter M. Saparoff, and Gaston Snow & Ely Bartlett, Boston, Mass., were on brief, for appellee Fidelity Municipal Bond Fund, Inc.

Richard A. Kirby, Sp. Counsel, Washington, D. C., with whom Ralph C. Ferrara, Gen. Counsel, Paul Gonson, Sol., Edward F. Greene, Gen. Counsel, Jacob H. Stillman, Associate Gen. Counsel, Robert Mills and Louis C. Whitsett, Attys., Washington, D.C., were on briefs, for the Securities and Exchange Commission, amicus curiae.

Before CAMPBELL, and BOWNES, *Circuit Judges*, and DAVIS,* *Judge*.

DAVIS, *Judge*.

Plaintiff-appellant Stanley M. Grossman brought this derivative action in the District Court for Massachusetts, under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 *et seq.* (1976) (the Act).[1] He is and has been a shareholder of Fidelity Municipal Bond Fund, Inc. ("the Fund"), a registered open-end investment com-

* Of the United States Court of Claims, sitting by designation.

1 For the purposes of our limited disposition, we rest on facts alleged by plaintiff in his amended complaint, and merely capsule the facts and proceedings.

pany, and he sues the Fund's investment adviser, Fidelity Management & Research Company ("FMR"), the corporation that is the sole owner of that adviser ("FMR Corp."), the affiliated directors of the Fund, as well as most of the unaffiliated directors (whom we shall call "disinterested").[2] Against these defendants, Grossman makes two charges: (a) breach of fiduciary duty to the Fund with respect to the allegedly excessive amount of advisory fees paid to FMR by the Fund; and (b) breach of fiduciary duty to the Fund by failing to recapture (or have recaptured) excessive underwriting commissions, discounts and spreads paid by the Fund on its purchases of securities. Before instituting the suit, plaintiff made no demand on the Fund or its directors to bring or prosecute an action on either of these two bases.

Defendants moved to dismiss the complaint, asserting, as one point, that plaintiff had failed to comply with Rule 23.1 of the Federal Rules of Civil Procedure, governing demand by shareholders in derivative actions. During the lengthy argument on those motions, the District Court suggested that it might be advisable, it might even end the controversy, for plaintiff to send a demand letter to the directors specifying his position, although the litigation had already commenced. After consideration, plaintiff did make such demand.

The District Court then stayed action on the motion and ordered the "disinterested" directors[3] to review the

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2 The "affiliated" directors own 5% or more of the shares of FMR Corp. and are officers and directors of FMR. The "unaffiliated" directors do not have those connections with FMR and FMR Corp.

3 These were the "unaffiliated" director defendants, plus one unaffiliated director who had not been sued though he had previously

demand and report back to the court. These directors delegated responsibility to a Special Committee composed of the two directors who were not defendants (*see* note 3, *supra*). The latter retained a former Chairman of the Securities and Exchange Commission (and his outside law firm) to make a study and render a report on the issues presented by plaintiff's demand. A lengthy report was made, concluding that there had been no statutory violation or breach of fiduciary duty on either branch of the suit, and recommending that the Special Committee seek to have this suit dismissed. The Committee accepted that recommendation.

Defendants then moved to dismiss the amended compalint,[4] and, alternatively, for summary judgment, urging two grounds which the District Court considered: (a) the failure to make a proper and timely demand, and (b) the court should accept the Special Committee's good faith "business judgment" that the suit should be terminated. In the decision now before us, the District Court accepted both of these contentions, alternatively. 89 F.R.D. 656 (1981). Judgment was entered for defendants. For the reasons to be given in Parts I, II and III of this opinion, we affirm on the former ground, by-passing the latter.

I

Rule 23.1 of the Rules of Civil Procedure ("Derivative Actions by Shareholders") declares:

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joined the board, and one unaffiliated director who became a board member after the suit had been brought (and accordingly was not sued).

4 In the course of the proceedings plaintiff had been permitted to file an amended complaint.

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Plaintiff urges that Rule 23.1 is wholly inapplicable to that portion of his case charging the payment of excessive advisory fees to the investment adviser (FMR), which is brought under the special provisions of section 36(b) of

the Act, 15 U.S.C. § 80a-35(b)(1976). In this segment of our opinion we consider that contention.[5]

Section 36(b), added in 1970, prescribes a separate statutory claim for excessive advisory fees to an investment adviser.[6] The Securities and Exchange Commission

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5 Plaintiff also says that, even if Rule 23.1 applies, he was excused from making a demand on the directors for this aspect of his complaint. We discuss that point in Part II, *infra*. As for the recapture of commissions, Grossman does not argue that Rule 23.1 is wholly inapplicable; he mainly says, instead, that he was excused from making a demand. We also consider that argument in Part II, *infra*. On both sectors of his case, plaintiff insists, in addition, that the demand he made after the beginning of the suit was adequate compliance with Rule 23.1. Part III, *infra*, deals with that premise.

The Securities and Exchange Commission, which participated in this appeal as amicus curiae, takes no position on the applicability of the demand provisions of Rule 23.1 or the alleged excuses for noncompliance.

6 The relevant parts of section 36(b) read:

> "(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments [including directors], for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:
>
> (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

and security holders of the investment company are specifically authorized to sue "on behalf of such company" to recover such fees. The section (among other limitations) places on the plaintiff the burden of proof of showing a breach of fiduciary duty, restricts monetary relief to actual damages and to the persons receiving such compensation, establishes a one-year statute of limitations on recovery, and provides that approval or ratification by the paying company's directors of the compensation to the investment adviser "shall be given such consideration by the court as is deemed appropriate under all the circumstances."

There is no express reference to Rule 23.1 or to demand by the suing shareholder, but plaintiff gives several reasons why, in his view, the structure, terms, and purpose of the provision show that the Rule is wholly inapplicable to such excessive fee suits. We divide these arguments into

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(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient."

three groups, first, those that we believe to have little merit, second, those that have substantial weight but are subject to countervailing arguments which likewise have merit, and then we discuss the considerations we believe to tip the balance against plaintiff on this question.

A.1. Appellant says initially that Rule 23.1 must be wholly inapplicable because, though the statute says that suit must be brought on behalf of the investment company and in that sense is a "derivative" action, section 36(b) does not permit an action by the investment company itself (but only by the SEC or a security holder).[7] We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees from the investment adviser, would be precluded from suing under section 36(b).[8] That section is explicit that recovery by a shareholder is to be on behalf of the investment company and that his suit must be brought on the same behalf. With those clear requirements, Congress could well have believed that, though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action under section 36(b), *see Moses v. Burgin*, 445 F.2d 369, 373 n.7 (1st Cir. 1971), it was unnecessary to say with particularity that the company also did. A suit "on behalf of such

7 The first sentence of Rule 23.1, *supra*, requires that "the corporation or association [shall have] failed to enforce a right *which may properly be asserted by it*" (emphasis added).

8 One reason why the directors might wish to use section 36(b), instead of employing a more conventional corporate suit, is that subsection (1) expressly removes the need to allege or prove "personal misconduct" on the part of any defendant. In addition, the general standard for recovery might be easier under section 36(b) than in a non-statutory action.

company" (a phrase which is more than merely one "for the benefit of the company") is normally a derivative action that the company could itself bring.

Plaintiff, whose complaint and amended complaint both allege that he brings this action "derivatively on behalf of the Fund," seems to have originally agreed that his suit under this section could have been brought by the Fund. Although subsection (3) directly forbids an action under section 36(b) against any person "other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments"—barring as defendants, in this instance, the "disinterested" directors and the Fund itself—this whole proceeding (including that part under section 36(b)) was brought against those "forbidden" defendants,[9] apparently on the correct assumption that this is a derivative suit to enforce rights the Fund could itself enforce, and in which the company and its directors should be joined in the ordinary fashion.

2. Another of plaintiff's points we reject outright is the analogy to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1976) ("profits from purchase and sale of security within six months"), which has been held excluded from certain non-demand parts of Rule 23.1. *Dottenheim v. Murchison*, 227 F.2d 737, 739-741 (5th Cir. 1955), *cert. denied*, 351 U.S. 919, 76 S.Ct. 712, 100 L.Ed. 1451 (1956); *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016, 74 S.Ct. 872, 98 L.Ed. 1138 (1954). On the demand point, however, section 16(b) is plainly inapposite because it embodies its

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9 This is also true of the amended complaint.

own express demand requirement different from that in Rule 23.1.[10] If anything, that special demand provision indicates that Congress considered a demand essential for a shareholder suit even though Congress may have dispensed with other aspects of what is now Rule 23.1.

3. A related argument we cannot accept is that section 36(b) speaks of suit by a "security holder", a term which it is said could cover pure debenture holders or other bare creditors who, not being shareholders or members, cannot comply with the demand aspects of Rule 23.1 The simple answer, we think, is that Congress used the general term "security holder" in section 36(b) to cover shareholders of mutual funds and like investors akin to stockholders, whom Rule 23.1 undoubtedly fits. The phrase was not designed to allow mere creditors to make use of section 36(b).[11]

B. Plaintiff makes three stronger arguments for total exclusion of the demand requirement of Rule 23.1—but each seems to us to have a substantial counterbalance.

1. Grossman's chief claim .. that a demand would be futile because the directors, even the "disinterested" ones, cannot by themselves terminate a section 36(b) suit

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10 Suit may be brought "if the user shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter * * * " 15 U.S.C. § 78p(b).

11 The legislative history of § 36(b) speaks of suits thereunder by "shareholders". *See* S.Rep.No. 184, 91st Cong., 1st Sess., *reprinted in* [1970] U.S.Code Cong. & Ad.News 4897, 4910; H.R.Rep.No. 2337, 89th Cong., 2d Sess. 143, 146 (1966) (SEC report); 115 Cong.Rec. 13699 (1969); *Investment Company Act Amendments of 1969: Hearings of the Senate Committee on Banking and Currency,* 91st Cong., 1st Sess. 1-2 (1969).

through the good faith exercise of reasonable "business judgment". We do not today decide whether or not the directors are so disabled—but it is undeniable that there are very serious reasons for accepting that proposition. *Burks v. Lasker,* 441 U.S. 471, 484, 99 S.Ct. 1831, 1840, 60 L.Ed.2d 404 (1979), a case on the directors' power to terminate a suit under other portions of the Act where section 36(b) was not involved, expressly contrasted the latter provision: "And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80—a—35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees."[12] The Supreme Court was referring to § 36(b)(2) (note 6, *supra*) which can easily be read to give the court, rather than the directors, the ultimate power to decide the propriety of the fees.

Nevertheless, even on that interpretation of the statute, a demand would not be futile. It would give the independent directors the opportunity to study the problem and decide whether to accede, in whole or in part, to the complainant's views. When it added § 36(b), Congress also deliberately strengthened the position of independent directors, including their dealing with advisory fees. *See Burks v. Lasker, supra,* 441 U.S. at 482-485, 99 S.Ct. at 1839, 1840-1841. They were not designed to be ciphers or to be overlooked. Although the court would decide for itself (on the view we accept *arguendo*) the merits of the

12 Though this statement may technically have been "dictum" in the sense that *Burks* did not itself involve section 36(b), the Court's observation formed an integral part of its reasons for holding that the directors had broader powers under other parts of the Act. The statement was by no means gratuitous or *obiter.*

claim of excessive compensation, the independent and disinterested directors still have a substantial role. Surely, their decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgeable disagreement with the demand might be deemed worthy by the court of grave consideration under § 36(b)(2).

2. Plaintiff's appeal to the legislative history (of the 1970 amendments) to show that section 36(b) was exempted from the demand requirement of Rule 23.1 seems, at the very best for him, to end in a draw. There was, as he points out, emphasis on the prior ineffectiveness of independent directors with respect to advisory fees, the need for strengthening then section 36, and the significant role of the courts in determining the proper level of fees. *See* the *S. E. C. 1966 Report on Investment Companies,* H.R.Rep. No. 2337, 89th Cong., 2d Sess., 131, 143, 146 (1966); *Investment Company Act Amendments of 1960: Hearings of the Senate Committee on Banking and Currency,* 91st Cong., 1st Sess. 1-2 (1969); S.Rep. No. 184, 91st Cong., 1st Sess., 2, 6-7, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4898, 4903; 115 Cong.Rec. 13699 (1969). But these themes are all fully consistent with the continued operation of the demand part of Rule 23.1, which would not impede or contradict any of the stated purposes. Indeed, the history shows an equal and concurrent stress on the authority and responsibility of the directors. S.Rep. No. 184, 91st Cong., 1st Sess. 7, *reprinted in* [1970] U.S. Code Cong. & Ad.News 4897, 4903. ("The section [section 36(b)] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders

from the directors of such company to the judiciary"; and "the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors"). At the same time, there was a concern to discourage unjustified derivative suits. H.R.Rep. No. 1382, 91st Cong., 2d Sess. 8 (1970); *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce,* 91st Cong., 1st Sess. 201, 662, 860 (1969). That aim is closely connected with Rule 23.1, which has such a goal among its functions.

When the inquiry narrows down to the continued relevance of the Federal Rules, especially Rule 23.1, there is some direct indication that the Rules were or may have been regarded as barriers to unjustified derivative suits. The Chairman of the Securities and Exchange Commission so reported. *Id.* at 201 (" * * * there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation"); to the same effect, *see id.* at 860, where the Chairman specifically mentioned "*e.g.* Rule 23, FRCP" as one of the "sufficient safeguards against frivolous or harassing lawsuits." Plaintiff cites a comment of another Commissioner disfavoring "the interposition of procedural obstacles", *Investment Company Act Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency,* 91st Cong., 1st Sess. 30 (1969), but this was a reference, not to the demand requirement of Rule 23.1, but to a proposed provision that a suing shareholder must own a specified percentage of stock or represent a stated amount of the investment fund's assets.

3. Lastly, plaintiff invokes the short one-year limitation period on damages[13] as sufficient reason for exempting § 36(b) cases from the demand provision of Rule 23.1—the time taken by demand-and-response before institution of an action would, it is argued, diminish the period and the amount of recovery. The truth is, however, that ordinarily the demand requirement could change the particular one-year period for which recovery was allowable but would not reduce the one-year recovery period, and probably not decrease the amount. In the unusual case in which the amount of recovery could actually be reduced by directors' dawdling or the taking of excessive time to reply to a demand, a district court could allow suit to go forward without awaiting a response. *See Mills v. Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D.Ill.1981).

C. The residue of our discussion (to this point) is that there is no strong reason for wholly excluding section 36(b) from the demand requirement, or for thinking that Congress intended that result. In subpart A, *supra*, we have rejected some of plaintiff's contentions outright, and in subpart B we have found that each of his more substantial points has a fair and equivalent counterpoise. The decisive factor, we must conclude, is that there is no persuasive indication that, in adopting section 36(b), Congress wished to repeal or limit the demand provision of Rule 23.1 which has long been a general part of our federal law of practice and procedure, governing almost all derivative actions in federal courts.

In the absence of a "clear inconsistency" or a demonstrated congressional purpose to exclude one or more of

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13 Section 36(b)(3) (note 6, *supra*) provides: "No award of damages shall be recoverable for any period prior to one year before the action was instituted."

the Federal Rules, "a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." 7 Moore's Federal Practice, ¶ 86.04[4] at 86-22 (2d ed. 1980); *United States v. Gustin-Bacon Division, Certain-Teed Products Corp.*, 426 F.2d 539, 542 (10th Cir.), *cert. denied,* 400 U.S. 832, 91 S.Ct. 63, 27 L.Ed.2d 63 (1970); *see also,* 4 C. Wright & A. Miller, Federal Practice & Procedure, § 1001 at 30-31 (1969 ed.)[14] That harmonization is quite feasible for section 36(b). Perhaps for such actions the demand requirement of Rule 23.1 may tend toward the status of a legal vermiform appendix—the provision's utility may be reduced sharply in § 36(b) litigation—but the demand requirement still has a function to perform and is not totally without purpose or effect. In those circumstances it is not for the courts to hold inapplicable the demand requirement "which continues a long tradition in the federal courts," *Heit v. Baird,* 567 F.2d 1157, 1160 (1st Cir. 1977), where Congress has not done so, explicitly or by solid implication.[15]

14 Compare this principle with the canon against implied repeals of the statutes in the absence of clear intention to do so or repugnancy of the later to the earlier legislation. *Morton v. Mancari,* 417 U.S. 535, 551, 94 S.Ct. 2474, 2483, 41 L.Ed.2d 290 (1974); *Georgia v. Pennsylvania R. R.*, 324 U.S. 439, 456-57, 65 S.Ct. 716, 725-726, 89 L.Ed. 1051 (1945).

15 In *General Telephone Co. v. EEOC,* 446 U.S. 318, 100 S.Ct. 1698, 64 L.Ed.2d 319 (1980), the Supreme Court ruled—on the basis of a "straightforward" reading of § 706 of the Civil Rights Act of 1964, the legislative intent underlying the 1972 to Title VII, and the enforcement procedures under Title VII—that the EEOC's enforcement action was not properly characterized as a "class action" subject to the procedural requirements of Rule 23. As we have said, comparable factors are absent here.

In addition to the court below, three district courts have passed directly on the applicability of the demand requirement of Rule 23.1

II

If, as we have held in Part I, *supra,* a § 36(b) action is not exempt from the demand portion of Rule 23.1, we must confront Grossman's secondary argument that, in any event, he was excused (as to the 36(b) portion of his suit) from making demand. He takes a parallel position for the "recapture" part of his action (which is not brought under § 36(b) and as to which plaintiff makes no claim of a complete exemption from the Rule). Rule 23.1 mandates that the complaint "shall also allege with particularity the efforts, if any, made by plaintiff to obtain the action he desires from the directors * * * and the reasons for his failure to obtain the action or for not making the effort." In this circuit that requirement has been "vigorously enforced." *Heit v. Baird, supra,* 567 F.2d at 1160. "The futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight." *Cramer v. General Telephone & Electronics Corp.,* 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied,* 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979).

1. On the advisory fees (the § 36(b) claim), plaintiff's only excuses are that the Fund's directors were controlled by or affiliated with FMR, had participated in the alleged

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to suits under section 36(b). Two have held Rule 23.1 applicable. *Markowitz v. Brody,* 90 F.R.D. 542, 548-49, 554-55, 559-61 (S.D.N.Y. 1981); *Weiss v. Temporary Investment Fund, Inc.,* 516 F.Supp. 665, 668-70 (D.Del. 1981), *rehearing denied,* 520 F.Supp. 1098 (1981). One court held primarily that demand was futile in that instance and therefore excused under Rule 23.1, but was also "inclined to agree with plaintiffs that a demand on the directors of the Fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital, Inc.,* S.D.N.Y., 528 F.Supp. 1152 (1982).

wrong, and had announced their opposition to the suit. All three reasons are inadequate. Of the eight Fund director-defendants, only three were affiliated with FMR; five were unaffiliated and "disinterested."[16] As the court said in *Untermeyer v. Fidelity Daily Income Trust*, 580 F.2d 22, 23 (1st Cir. 1978), and *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973), a majority of disinterested directors negatives general allegations of control-by-the-adviser, comparable to those plaintiff makes here. A proper excuse of control or domination calls for particularized allegations and specific facts—which are absent both in the initial and the amended complaint.

As for mere 'participation" or "acquiescence" by the directors in the level of the challenged advisory fees, that generality, too, is an insufficient excuse where the corporate activity is the normal one of setting and paying advisory fees; on this point, there also are no particulars asserting that a majority of the directors engaged in a "facially improper transaction." Bare allegations of "wrongful participation" or "acquiescence" are not enough in this circuit. See *In re Kauffman Mutual Fund Actions, supra*, 479 F.2d at 264-65; *Heit v. Baird, supra*, 567 F.2d at 1160-62.

The third allegation, that the directors had already announced their firm opposition to the suit, is equally unavailing. Apart from the critical fact that the statement on which plaintiff relies in his amended complaint did not precede the suit but was part of a motion to dismiss the initial complaint, there is no doubt whatever that, in

16 One disinterested director (who was apparently such at the time suit was begun) was not sued.

context, the disinterested directors' position did not preclude their fair consideration of plaintiff's demand.[17]

2. The primary excuse for failing to make demand on the "recapture" element of the case is that the directors all had a conflict of interest.[18] The gist of this claim is that FMR should have recovered a substantial portion of underwriting commissions, discounts and spreads paid on the Fund's purchases of municipal bonds, but failed to do so "because FMR received from the underwriters substantial benefits in the form of research, statistical and other information in connection with FMR's functions as investment adviser *to the other funds which it manages*" (emphasis added). The posited conflict-of-interest arises because all the Fund's directors are directors or trustees of other funds managed by FMR, and as such directors or trustees (it is asserted) would have an interest adverse to recapture for the Fund, so that the other funds could continue to receive the information they need and want.

We can assume *arguendo* that there might arguably be some duty to recapture as charged in the complaint, but the difficulty with plaintiff's general assumption of "conflict of interest," as an excuse for not making demand, is

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17 The full statement was: "The Disinterested Directors have no basis for believing that suit against FMR for the practices alleged in the Complaint is justified. They are anxious, however, to evaluate any information which Grossman has which suggests that it is. If they concluded that suit is justified, the Fund's best interests demand that they bring suit. They will do so."

As ground for his excuse, Grossman quotes only the first sentence, omitting the remainder.

18 Plaintiff also says, on this phase, that the directors had announced their firm opposition to the merits of his recapture claim. On that, the answer we have already given (*see* note 17, *supra*, and text) suffices.

that he fails to set forth with any specificality, as Rule 23.1 and our decisions require, the factual grounds why this putative "conflict of interest" was in fact an actual one. The conflicting status of the Fund's directors here was at best tenuous and conditional, not direct, stark, apparent and "unmistakable" as in *Delaware & Hudson Co. v. Albany & Susquehanna Railroad,* 213 U.S. 435, 29 S.Ct. 540, 53 L.Ed. 862 (1909). The responsibility both for supplying the information to the other funds and for recapture was, not on the other funds, but on FMR, with which a majority of the Fund's board were unconnected. The same is true of the financial detriment of recapture, which would fall on FMR; the other funds would not be interested in that money. They may be concerned with continuing to receive the information,[19] but there is no allegation or reason to believe that they would not be satisfied if FMR obtained it elsewhere than from underwriters, brokers or dealers. Although there is an allegation that recapture would diminish the amount of information supplied by the latter, there is no assertion that FMR (which had the duty to supply it) would not be able to, or would not, fill the gap from another source, nor is there any assertion that the other funds would have to pay FMR higher fees in order to obtain the information they wanted. To charge a true conflict of interest the plaintiff should have at least spelled out the likelihood of one, not left the court with the bare possibility that the defendants might conceivably have the incentive to vote or push against recapture because of their interests as directors of the other funds. *Heit v. Baird, supra,* 567 F.2d at 1161-62, indicates tht the bare possibility or mere

19 There are, however, no particularized allegations on the necessity or importance of the other funds' continuing to receive the information.

allegation that the directors could have a self-interested purposed (there, to retain control of the corporation; here, to advance the interests of the other funds) is not enough if, as in this case, there can be valid corporate reasons for taking the position challenged in the complaint—or if there is in fact no conflict because of other circumstances not negated by plaintiff. Conversely, "the antagonism between the directory and the corporate interest" must be shown to be "unmistakable," or deemed futile, to excuse demand. *Delaware & Hudson Co. v. Albany & Susquehanna Railroad,* 213 U.S. 435, 447, 29 S.Ct. 540, 543, 53 L.Ed. 862 (1909); *In re Kauffman Mutual Fund Actions, supra,* 479 F.2d at 263.

III

The final question is whether plaintiff's post-litigation demand cured his failure to make one before beginning the action. Rule 23.1 specifically calls upon the complaint to show that demand was made or was properly excused; there is no provision for thereafter remedying an omission in the same suit, especially after the defendants have moved to dismiss because of the absence of a demand. The terms of the Rule have generally been followed by other appellate courts. *Lucking v. Delano,* 117 F.2d 159, 160 (6th Cir. 1941) ("Obviously the filing of the complaint cannot be regarded as a demand to sue, for by starting the action [plaintiffs] have usurped the field"); *Shlensky v. Dorsey,* 574 F.2d 131, 141-42 (3rd Cir. 1978) ("The contemplated showing of demand made upon the directors after the filing of the shareholders' derivative complaints could not have satisfied the demand requirements of the rule"); *Galef v. Alexander,* 615 F.2d 51, 59 (2d Cir. 1980) ("Rule 23.1 * * * is essentially a requirement that a

stockholder exhaust his intracorporate remedies before bringing a derivative action").

Though this court has not yet ruled squarely on the precise point, it has observed that the rule of demand is to alert the director before suit is instituted. *In re Kauffman Mutual Fund Actions, supra,* 479 F.2d at 263, we said that "to be allowed, sua sponte, to place himself in charge without *first* affording the directors the opportunity to occupy their normal status, a stockholder must show that his case is exceptional," *i.e.* that demand is excused (emphasis added). The same postulate was expressed in *Heit v. Baird, supra,* 567 F.2d at 1162 (n.6): "The purpose of the demand requirement is, of course, to require resort to the body legally charged with conduct of the company's affairs *before* licensing suit in the company's name by persons not so charged" (emphasis added). Under this court's practice of vigorous enforcement of the Rule (*Heit v. Baird,* 567 F.2d at 1160; *see also In re Kauffman Mutual Fund Actions,* 479 F.2d at 263, 267), and of the generally "strict view" the court takes "of the requirement of prior demand" (*Untermeyer v. Fidelity Daily Income Trust,* 580 F.2d 22, 23 (1st Cir. 1978)), these statements should be, and are, now embodied in an explicit holding.

It makes no difference that in this instance the belated demand was made at the suggestion of the District Court. The judge's colloquy with counsel shows that the court was simply making that suggestion, as the opinion below says, "in the hope that expensive and lengthy litigation could be avoided"; if the directors responded favorably to plaintiff, in whole or in part, that would clearly be the result. Grossman then made his demand voluntarily, with his expressed understanding "that the demand letter

would not be deemed a waiver by any party of rights which it otherwise possessed." There was no direction by the court and no agreement that the late demand would rectify the initial failure to make a demand prior to suit.

IV

Because we hold that the suit must be dismissed because plaintiff did not make the necessary demand before suing, we refrain from considering the District Court's alternative holding that, in any event, defendants are entitled to judgment on the ground that their "alleged actions are protected by and comply with the requirements of the business judgment rules."

Affirmed.

Decision of the Court of Appeals for the Third Circuit in
Weiss* v. *Temporary Investment Fund

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-2688

MELVYN I. WEISS, Custodian for
GARY MICHAEL WEISS, U/NY/UGMA,
Appellant

v.

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES, INC., RUSSELL W. RICHIE, ROBERT R. FORTUNE, JAMES LOUIS ROBERTSON, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, G. WILLING PEPPER
Appellees

(D.C. Civil No. 80-00230)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE

Argued April 2, 1982

Before: GIBBONS, SLOVITER and BECKER, *Circuit Judges*

(Opinion Filed November 12, 1982)

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OPINION OF THE COURT

BECKER, *Circuit Judge*.

The principal question presented in this appeal is whether a shareholder of an investment company must make a demand on directors pursuant to Fed. R. Civ. P. 23.1 prior to commencing suit under section 36(b) of the Investment Company Act of 1940 (ICA), 15 U.S.C. §§80a-35(b) (1976), to challenge the company's contracts with its investment advisers. The district judge dismissed the action for failure to satisfy the demand requirement, *Weiss v. Temporary Investment Fund, Inc.*, 516 F. Supp. 665 (D. Del. 1981), and denied the appellant leave to replead after making a demand, *Weiss v. Temporary Investment Fund, Inc.*, 520 F. Supp. 1098 (D. Del. 1981).

Appellant Weiss contends that the ICA was a product of Congress' recognition of potential conflicts of interest in the management of investment companies and that the ICA's legislative history and statutory scheme, which reflect that concern, are inconsistent with the re-

quirement of shareholder demand. After reviewing that legislative history and statutory scheme and the purposes of the demand requirement, we perceive no such inconsistency. We conclude that the contributions of the demand requirement to corporate governance mandate application of Rule 23.1 to section 36(b) suits. We also conclude that the circumstances alleged in the complaint do not warrant excusing such a demand as futile, and the district judge did not err in denying leave to replead. We therefore affirm.

I. *INTRODUCTION*

A. *Factual and Procedural Background*

Plaintiff-appellant Melvyn I. Weiss, as custodian for his son Gary Michael Weiss, is a shareholder of the Temporary Investment Fund, Inc. (the Fund). The Fund is a no-load open-end investment company, commonly referred to as a "money market fund," whose objective is to increase the current income of its shareholders through investments in a variety of prime money market obligations. The Fund is managed by a seven-member board of directors elected by its shareholders.[1]

Under an Advisory Agreement, the management of the Fund's portfolio is entrusted to its investment adviser, Provident Institutional Management Corporation (the Adviser), a wholly-owned subsidiary of Provident National Bank (Provident). Under a sub-advisory agreement, Provident receives seventy-five percent of the Adviser's fees, in return for which it supplies, *inter alia*, investment research services, computer facilities, and operating personnel. Shearson Loeb Rhoades, Inc. (Shearson) serves as underwriter for the Fund and performs other administrative functions under its Administration and Distribution Agreement with the Fund.

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1. In January 1980, when the advisory contracts at issue were approved, the board consisted of six members.

The terms of the Advisory and Administration Agreements (collectively referred to as "advisory contracts") provide that the fees received by the Adviser and Shearson are computed as a percentage of the Fund's assets. The percentage rate is scaled downward: Shearson and the Adviser each received .175 percent of the first $300 million in assets, .15 percent of the next $300 million, and .125 percent of the third $300 million. For average net assets in excess of $900 million, the rate is fixed at .1 percent. The recent popularity of money market funds has dramatically increased the Fund's assets, to more than $2 billion when suit was commenced in 1980. This phenomenon has produced a commensurate increase in the fees received by the Adviser and Shearson.

On May 7, 1980, Weiss brought a shareholder suit on behalf of the Fund against the Adviser, Shearson, and seven directors of the Fund. One count of the complaint charges that Shearson and the Adviser breached their fiduciary duties to the Fund under section 36(b) of the ICA by receiving "excessive and unreasonable" compensation. The basis of this count is the advisory contracts, which Weiss contends permit the Adviser to receive twenty-five percent of the fees without performing any services and fail to provide for any reduction in fees after the Fund's assets exceed $900 million. Additional counts allege that all defendants breached their fiduciary duties by participating or acquiescing in the advisory contracts; that shareholder approval of the fee arrangements was secured through misleading proxy statements in violation of section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78n(a) (1976); and that the management and fee arrangements violate the Banking Act of 1933, 12 U.S.C. §§24, 378(a) (1976), the ICA, and common law fiduciary duties. As relief, the plaintiff sought a judgment declaring the Advisory Agreement and the Distribution Agreement void, an or-

der requiring that the Adviser and Shearson repay all excessive fees to the Fund, and an order requiring the individual defendants to reimburse the Fund for damages caused by their violations of the ICA and the Securities Exchange Act.

The complaint acknowledges that no demand was made on the directors of the Fund. It asserts, however, that demand is not a prerequisite for the section 36(b) count and that demand would have been futile as to all counts because the directors are controlled by the Fund's advisers and because they participated in the alleged violations. Amended Complaint at ¶37.

The defendants moved to dismiss the complaint on a number of grounds, including the plaintiff's failure to satisfy the Rule 23.1 demand requirement. The district court, concluding that demand is required for a section 36(b) suit and was not excused as futile, dismissed the complaint.[2] Having determined that intra-corporate remedies should be exhausted first, the court found it unnecessary to address the other challenges to the complaint. The court subsequently denied Weiss' motion seeking leave to make a demand on the directors and to file an amended complaint if demand was refused. Weiss appeals from all three rulings.

As we indicated at the outset, section 36(b) is the principal focus of our attention. Its relevant portions are set forth in the margin.[3] Although section 36(b) does not

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2. The court also dismissed the action against defendant James L. Robinson for insufficient service of process. That portion of the district court's order has not been appealed.

3. Section 36(b) provides, in relevant part:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such in-

explicitly excuse shareholders from the demand requirement of Rule 23.1, Weiss advances two theories to support his position that demand is not required. First, he argues that because the statute does not authorize a cause of action by the corporation, a section 36(b) suit is not derivative and is thus not governed by Rule 23.1 at all. Alternatively, he asserts that the legislative history and the statutory scheme supersede the policies underlying the requirement of shareholder demand. Although he presents a number of discrete arguments to support this latter thesis, their common predicate is that Congress, perceiving directors of investment companies to be ineffective checks on advisory fee levels, structured section 36(b) to permit shareholders to bypass the directors. Before considering Weiss' specific contentions, we must describe the contours of section 36(b) and other relevant provisions of the ICA.

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vestment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or ap-

B. *The Statutory Scheme*

The management of an investment company is distinguished by its reliance on external management and investment advisers. *See, e.g., Burks v. Lasker*, 441 U.S. 471, 480-85 (1979); *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977); Note, *Mutual Fund Independent Directors: Putting a Leash on the Watchdogs*, 47 Fordham L. Rev. 568 (1979) [hereinafter cited as Fordham Note]. Typically, an external organization such as Shearson creates the investment fund and appoints the initial board of directors. The board then enters into a contract with one or more external companies who manage the fund and provide investment services. In addition to receiving fees for these two functions (which may be performed by the same outside adviser), the independent advisers may receive underwriting fees or brokerage commissions if they also serve in those capacities. This web of financial ties among the fund and its advisers invites several con-

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NOTE —(*Continued*)

> proval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.
>
> (3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

15 U.S.C. §80a-35(b) (1976).

flicts of interest. In negotiating advisory fees, for example, directors affiliated with the adviser face the competing interests of the adviser, who seeks high fees, and the investors, who want low fees in order to maximize their return on investment. Similarly, an adviser who also serves as broker has an incentive to increase its fees through frequent portfolio transactions that may dissipate the earnings of the investors. *See* Fordham Note, *supra* p. 7, at 570-71.

The ICA was intended to minimize the potential conflicts arising from the creation, sale, and management of an investment company such as a mutual fund by external investment advisers. S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901. As originally enacted in 1940, the ICA's principal device to prevent self-dealing by the directors was the requirement that at least forty percent of the board members be independent — that is, that they have neither a direct nor an indirect financial interest in the company or its adviser. 15 U.S.C. §80a-10(a) (1976). Over time, however, it became apparent that this safeguard was insufficient to stem the burgeoning advisory fees. Recognizing that a company's dependency on its adviser limited the influence of arms-length bargaining in keeping advisory fees competitive, Congress enacted section 36(b) as part of the 1970 amendments to the ICA. That section imposes on the adviser a fiduciary duty with respect to compensation for its services and explicitly authorizes suits by the Securities and Exchange Commission and the fund's shareholders to enforce that duty. By increasing the standard of care owed by the advisers, Congress sought to ease the difficult burden faced by shareholders trying to prove that advisory contracts violated common law prohibitions against "corporate waste." *See infra* note 9. The remedy under 36(b) is an action against the recipient of the allegedly excessive payments for actual damages resulting from the breach of fiduciary duty, not to exceed actual pay-

ments received from the investment company. A showing of personal misconduct by the defendant is not required. The recovery of excessive fees is limited to those paid by the investment company during the one-year period prior to initiation of the suit.

Additional responsibility for monitoring management fees were also imposed on directors. The 1970 amendments require directors to investigate and evaluate advisory fee contracts, demand that a majority of disinterested directors approve the contracts, and permit the directors to terminate contracts without financial penalty upon sixty days' notice. 15 U.S.C. §80a-15(c) (1976). The amendments also tightened the qualifications of the independent directors serving on the board. *Id.* §§80a-2(19), 80a-10a.[4] The essence of the amendments, as the Supreme Court has noted, is to place these unaffiliated directors in the role of "independent watchdogs" charged with supervising the management of the company. *Burks v. Lasker, supra*, 441 U.S. at 484.

With this background in mind, we turn to Weiss' arguments that suits under section 36(b) are not subject to Rule 23.1.

II. *IS A SECTION 36(b) ACTION DERIVATIVE?*

Before addressing the arguments set forth in the briefs, we must consider a threshold contention — advanced by Weiss for the first time at oral argument — that a shareholder suit under section 36(b) is not a derivative action and thus is not subject to Rule 23.1.[5]

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4. Independent directors are those who are not "interested" in the company or its advisers. The amendments define "interested person" to include persons who have close family ties or substantial financial or professional relationships with the investment company or its advisers, or who have beneficial or legal interests in securities issued by the adviser or underwriter.

5. The belated nature of this argument is evidenced by Weiss' pleadings, which characterize the action as one brought "derivatively on behalf of the Fund." Amended Complaint at ¶2(b).

Weiss apparently relies on the rule's requirement that the right enforced by a shareholder be one which "may properly be asserted" by the corporation.[6] The ICA, however, explicitly authorizes suits only by the SEC and by the shareholders and does not state that the Fund itself may sue its advisers for breach of fiduciary duties. If the Fund cannot sue, Weiss' theory proceeds, then a section 36(b) cause of action does not derive from a right that "may properly be asserted" by the Fund. We disagree.

We can approach this issue in several ways. One approach, adopted by the First Circuit in *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 192), *cert. denied*, 51 U.S.L.W. 3245 (U.S. Oct. 5, 1982), views an investment company's right to sue its advisers as a necessary, if not explicit, corollary of the right of action conferred on shareholders by section 36(b). In holding that an investment company has a direct cause of action under section 36(b), the *Grossman* court stated:

> We cannot believe . . . that, for example, a new and independent board of directors, intent on recovering excessive fees from the investment adviser, would be precluded from suing under section 36(b). That section is explicit that recovery by a shareholder is to be on behalf of the investment company and that

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6. Rule 23.1 states in pertinent part:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation, . . . the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort.

The Rule establishes other derivative suit requirements such as contemporaneous ownership of stock by the plaintiff when the alleged wrong occurred. These additional requirements are not at issue in this appeal and references here to "Rule 23.1" are limited to the demand requirement unless otherwise noted.

his suit must be brought on the same behalf. With those clear requirements, Congress could well have believed that, though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action under section 36(b), *see Moses v. Burgin*, 445 F.2d 369, 373 n.7 (1st Cir. 1971), it was unnecessary to say with particularity that the company also did. A suit 'on behalf of such company' (a phrase which is more than merely one 'for the benefit of the company') is normally a derivative action that the company could itself bring.

Id. at 120 (footnotes omitted).[7] Along similar lines, the Supreme Court noted in *Burks v. Lasker, supra*, 441 U.S. at 477, that "[a] derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation" (emphasis supplied), and the Court thereafter referred without comment to a section 36(b) suit as derivative, *id.* at 484.

We agree with the First Circuit's reasoning as far as it goes, but we expand our analysis to consider the test enunciated in *Cort v. Ash*, 422 U.S. 66 (1975). *Cort* provides the generally accepted framework for determining whether a statute creates an implied right of action.[8]

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7. The Second Circuit has rejected this argument. Fox v. Reich & Tang, Inc., No. 82-7296 (2d Cir. October 26, 1982); *see infra* pp. 13-14.

8. We recognize that implication of the corporation's right of action by a statute expressly authorizing suit by shareholders is somewhat atypical of the cases employing the *Cort* test. Three recent Supreme Court opinions illustrate the usual application of the *Cort* test in situations where the statute fails to specify either a private remedy or a cause of action for the particular relief sought. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825 (1982) (finding private rights of action for violations of the Commodity Exchange Act); Middlesex County Sewerage Authority v. National Sea Clammers Ass'n, 453 U.S. 1 (1981) (finding no implied private right of action for damages under the Federal Water

Our application of the *Cort* test leads us to the same conclusion as the First Circuit.

Cort counsels consideration of four factors:

> First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,' — that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law.

Cort v. Ash, supra, 422 U.S. at 78 (citations omitted). With respect to the first factor, we have no difficulty in concluding that an investment company is the intended beneficiary of section 36(b). The legislative history states that the fiduciary duty imposed on advisers, one of the major innovations of the statute, is owed to the company itself. S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4902. Moreover, as Weiss concedes, any recovery obtained in a shareholder suit reverts to the investment company and not to the plaintiff.

The second factor, ascertainment of Congress' intent, is the principal focus of the *Cort* inquiry. *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825, 1839 (1982); *see Walck v. American Stock Exchange, Inc.*, No. 82-1051, slip op. at 6, 10 (3d Cir. Sept.

Pollution Control Act or the Marine Protection, Research, and Sanctuaries Act of 1972); Texas Industries, Inc. v. Radcliff Materials, Inc., 451 U.S. 630 (1981) (antitrust laws do not give rise to implied right of contribution).

1, 1982). We find nothing in the legislative history of the ICA that suggests an intent to deprive the company of a direct remedy. Neither, we must concede, do we find an explicit expression by Congress that the investment company is authorized to sue its adviser. But our conclusion is unaffected by this absence of express authorization for, as the Supreme Court noted in canvassing the same legislative history, silence regarding the powers of the board of directors is to be expected: "The ICA does not purport to be the source of authority for managerial power; rather, the Act functions primarily to 'impos[e] *controls and restrictions* on the internal management of investment companies.'" *Burks v. Lasker, supra*, 441 U.S. at 478 (citation omitted) (emphasis in original). Thus we may properly infer from this legislative silence that Congress did not intend to restrict the company's right to sue.

The state of the law at the time of the 1970 amendments supports this construction of the legislative history. We are required to look at this "contemporary legal context" to determine whether the company had a right to sue when the statute was enacted. If such a right existed, we need only determine whether Congress intended to preserve the preexisting remedy. *See Merrill Lynch, Pierce, Fenner & Smith v. Curran, supra*, 102 S. Ct. at 1839. In this regard, we agree with the district court's observation, *see* 516 F. Supp. at 670 n.11, that the company possessed (and still possesses) a cause of action against the adviser at common law.[9] We also note

9. The common law predecessor to a section 36(b) action was a suit against the adviser for "corporate waste," an action traditionally deemed to be derivative. 13 W. Fletcher, *Cyclopedia of the Law of Private Corporations* ¶¶5924, 5926, 5927 (rev. perm. ed. 1980). Congress found the burden of proving corporate waste "unduly restrictive" and created the fiduciary duties in section 36(b) to reduce the burden of invalidating advisory contracts. S. Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901. Because the common law action was derivative, we assume Congress expected the federal action to be derivative as well.

that a shareholder's right to sue *derivatively* was implied by former section 36 (now section 36(a)), which authorizes SEC enforcement of the ICA's regulatory scheme. *See, e.g., Moses v. Burgin,* 445 F.2d 369 (1st Cir. 1971) (finding implied right of action under former section 36 for shareholder to sue derivatively to recapture excessive brokerage fees paid by the mutual fund). "Where Congress adopts a new law incorporating sections of a prior law, Congress can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute." *Merrill Lynch, Pierce, Fenner & Smith v. Curran, supra,* 102 S. Ct. at 1841 n.66. Against this legal backdrop at the time of the amendments, Congress' assumption that the shareholder suit was derivative from the company's right of action becomes clear, as does the correctness of the First Circuit's conclusion that Congress assumed the company enjoyed a direct cause of action and there was no need to so specify. In sum, the second *Cort* criterion is met for the reasons set forth by the First Circuit in *Grossman* and because we find no evidence of a Congressional intent to deprive the company of its right to sue the company's adviser.

The third and fourth factors of the *Cort* test follow ineluctably from the preceding discussion. Providing the investment company with a cause of action fully accords with the purposes of section 36(b) by providing another means to recover excessive advisory fees. From a practical standpoint, in fact, the company's financial resources and knowledge of the challenged transactions may render it an even more effective litigant than the shareholder. Finally, the express cause of action conferred by Congress upon shareholders *ipso facto* federalizes this type of litigation; hence implication of a companion remedy for the investment company does not intrude upon an area "traditionally relegated to state law." Thus application of the four-pronged test of *Cort v. Ash* compels us to conclude that the investment com-

pany has a cause of action against the advisers for breach of the fiduciary duties imposed by section 36(b). We are aware that the Court of Appeals for the Second Circuit recently reached the opposite conclusion. *Fox v. Reich & Tang, Inc.*, No. 82-7296 (2d Cir. Oct. 26, 1982). After careful consideration of the court's reasoning, however, we remain convinced that the investment company has a cause of action and that a §36(b) action is derivative.

III. *IS SECTION 36(b) CONSISTENT WITH THE DEMAND REQUIREMENT?*

Even if a section 36(b) suit is derivative, Weiss insists that the ICA excuses such suits from the Rule 23.1 demand requirement. As we have noted, he concedes that the statute does not do so expressly, but contends that the legislative history and statutory scheme of section 36(b) manifest Congress' intent to eliminate this prerequisite to suit.

At the outset we note that Weiss must overcome the presumption that Rule 23.1, like all Federal Rules of Civil Procedure, applies to any civil suit brought in federal district court unless inconsistent with an Act of Congress. Fed. R. Civ. P. 1; *see* 28 U.S.C. §2071 (1976). Abrogation of a rule of procedure generally is inappropriate "[i]n the absence of a direct expression by Congress of its intent to depart from the usual course of trying 'all suits of a civil nature' under the Rules established for that purpose." *Califano v. Yamasaki*, 442 U.S. 683, 700 (1979). Repugnancy of a statute to a civil rule is not to be lightly implied. Rather, "a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." *Grossman v. Johnson*, *supra*, 674 F.2d at 122-23 (quoting 7 *Moore's Federal Practice* ¶86.04[4] at 86-22 (2d ed. 1980)); *accord Fox v. Reich & Tang, Inc.*, 94 F.R.D. 94 (S.D.N.Y. 1982), *rev'd on other grounds*, No. 82-7296 (2d Cir. Oct. 26, 1982).

A. *Does the Legislative History Reflect Congress' Intent to Require Demand?*

Weiss relies first on the legislative history accompanying the 1970 amendments, passages of which reflect Congress' perception that even unaffiliated directors had not been able to secure changes in the advisory fee levels. For example, he quotes from the Securities and Exchange Commission Report on Investment Companies, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966):

> It has been the Commission's experience in the administration of the Act that in general *the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry.*
>
> . . .
>
> The analysis of the shareholder fee litigation not only underscores the need for changes in existing statutory provisions relating to management compensation in the investment company industry, but points to the direction which these changes should take. It makes clear the need to incorporate into the Act a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid by investment companies for services furnished by those who occupy a fiduciary relationship to such companies.
>
> . . .
>
> The right of the *Commission as well as investment company shareholders* to take action against violations of the *statutory standard of reasonableness* is essential to effective enforcement.

Id. at 131, 143, 146 (emphasis supplied by appellant). Second, he invokes the Congressional intention to establish a mechanism by which the shareholders and courts

could enforce the investment adviser's fiduciary duty. The report accompanying the 1970 amendments states:

> In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, *there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty.*

S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4898 (emphasis supplied by appellant).

These passages do not reflect a "direct expression by Congress" of its intent to eliminate the demand requirement. Expressions that shareholders and the SEC need increased judicial access in order to insure the reasonableness of advisory fees do not denote an intent to bypass the directors completely. On the contrary, the legislative history is replete with references to Congress' intent to preserve, not preempt, the role of management in negotiating advisory fees. The Senate Report emphasizes this point:

> [Section 36(b)] is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. . . . Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an

investment company in the best interest of its shareholders from the directors of such company to the judiciary.

S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4902-03. The clear intent of Congress was to install management as "the first line of defense for the individual investor" against any self-dealing by the adviser. *Fox v. Reich & Tang, Inc., supra*, 94 F.R.D. at 96. As the Supreme Court noted in *Burks v. Lasker, supra*, 441 U.S. at 484-85, the 1970 amendments were designed to place the unaffiliated directors in a "watchdog" role. Requiring that shareholders make a demand upon the directors is fully consonant with this purpose.

Requiring demand also accords with the legislative history, which itself alludes to the continued operation of the demand requirement. During Congressional hearings on the proposed amendments to the ICA, then SEC Chairman Hamer Budge assured the committee that providing shareholders with a cause of action would not encourage nuisance suits: "As we have pointed out previously, there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation." *Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 201 (1969); *accord id.* at 860. It is clear to us that this statement refers to Rule 23.1 and its demand requirement. Contrary to Weiss' suggestion, the legislative history reflects an implicit understanding that Rule 23.1 would apply — an understanding which comports with the purposes of section 36(b).

B. *Is the Statutory Scheme Consistent with the Requirement of Shareholder Demand?*

Weiss' final arguments regarding the alleged inapplicability of Rule 23.1 spring from his contention that

the structure of section 36(b) is inconsistent with the requirement of shareholder demand, and that Congress therefore did not contemplate demand as a prerequisite to suit. Weiss makes three arguments. The first two require only brief discussion; the third merits more extensive treatment.

1. *The Effect of the One-Year Limitation on Recovery*

Weiss asserts that demand cannot be required because: (1) section 36(b) limits the recovery of unreasonable fees to those that were paid during the one-year period prior to commencement of suit; (2) once a shareholder plaintiff makes a demand, the directors can delay a response while the excessive fees continue to be paid; and (3) Congress could not have intended to interpose the demand requirement because the time consumed by the directors in responding to demand would time-bar claims to recover fees paid out by the investment fund. At least one court has identified this statutory provision as a basis for suggesting, in dictum, that demand should not be a prerequisite to a section 36(b) suit. *See Blatt v. Dean Witter Reynolds Intercapital, Inc.*, 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982).

We recognize that in some cases, demand will postpone the filing of suit and thereby move forward the one-year period allowed for the recovery of fees. In most instances, however, this will not reduce the allowable recovery. In any event, we do not see why demand cannot be promptly made and expeditiously considered.[10] Notwithstanding Weiss' intimations to the contrary, de-

10. The First Circuit, in rejecting the identical argument, suggested that the district court could allow suit to go forward without waiting for a response if the directors unduly postpone a response to demand. *Grossman v. Johnson, supra*, 674 F.2d at 122. We intimate no view here concerning the propriety of that suggestion.

mand is a simple procedure that is not burdensome to the shareholders. We therefore do not believe that the one-year limitation period compels the conclusion that Congress intended to eliminate the demand requirement.[11]

2. *The Analogy to Section 16(b) of the Securities Exchange Act of 1934*

Weiss advances a somewhat tortured analogy between section 36(b) of the ICA and section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b) (1976), which allows shareholders to recover illegal insider "short swing" profits. Suits brought under section 16(b) are exempt from the contemporaneous ownership requirement of Rule 23.1. *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954). Weiss perceives similarities between insider trading and "insider" advisory fees. He suggests that section 36(b), like section 16(b), is an instrument of public policy which should not be hampered by procedural restrictions such as the demand requirement of Rule 23.1.

Without reaching the merits of the statutory analogy, we simply note that it is irrelevant: suits to recover short swing profits under section 16(b) are subject to the demand requirement by the very terms of that statute, which states that a shareholder may institute an action "if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter." 15 U.S.C. §78p(b) (1976). We therefore join the First Circuit in rejecting this argument as specious. *See Grossman v. Johnson, supra*, 674 F.2d at 120.

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11. Additionally we note that the short statute of limitations may reflect a Congressional view of the ICA as designed to ameliorate the situation prospectively rather than to establish a long damage period.

3. *The Relationship Between Shareholder Demand and the Exercise of the Directors' Business Judgment*

The heart of Weiss' challenge based on the statutory scheme is his assertion that shareholder demand is superfluous because that scheme effectively precludes the Fund's directors from taking action in response to any such demand. The premise of his argument is the Supreme Court's suggestion that the ICA deprives the directors of their authority to exercise their business judgment to terminate a section 36(b) suit. In *Burks v. Lasker, supra*, the Court stated:

> when Congress . . . intended to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

441 U.S. at 484. Although section 36(b) was not directly at issue in *Burks*, the Court's interpretation of that section influenced its holding that other sections of the ICA do *not* deprive directors of their authority to terminate derivative suits under the shield of the business judgment rule. Prudence dictates that we accede to this strong signal from the Court that directors may not terminate suits under section 36(b), notwithstanding our perception that the statement's import is unclear. *See infra* pp. 21-22.

Weiss then argues that if a suit's termination is precluded, it would be inconsistent to require demand as a prerequisite to initiation: if directors are too self-interested to be allowed to cut off shareholder suits in the exercise of their business judgment, they must be presumed to be too self-interested to respond objectively to a shareholder demand. Relying in part upon our observation in *Cramer v. General Telephone and Electronics Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*,

439 U.S. 1129 (1979), that the business judgment rule is "inextricably linked" to the demand requirement. Weiss essentially concludes that the Court's inclination to disregard business judgment in this context makes the demand requirement superfluous and inefficient.

Our opinion in *Lewis v. Curtis*, 671 F.2d 779 (1982), lends some credence to Weiss' position.[12] *Lewis* involved a shareholder complaint alleging that demand would have been futile because the directors had participated in an allegedly self-interested transaction.[13] In evaluating this claim, we stated that the futility of demand turns on the disinterestedness of the directors, not on the nature of the alleged wrongdoing. We also noted that the relevant standard of disinterestedness is the same as that used to determine whether a court should defer to the board's business judgment not to pursue a lawsuit on behalf of the corporation.

> There is no reason why a court, in deciding whether a board is sufficiently interested to excuse demand, should not be informed by the same factors used to determine whether a court should defer to the board's decision not to pursue the action. The board will lack such disinterestedness if plaintiff's allegations, taken as true, would show that, under state law, a court should not defer to the board's decision not to pursue the lawsuit. . . .

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12. *Lewis* was published after the briefs in this appeal were filed.

13. The directors were accused of entering into a wasteful settlement agreement with a shareholder. Pursuant to the agreement the shareholder abandoned his proxy contest in which he was seeking a seat on the corporation's board. The complaint also alleged details of a larger scheme by the directors to retain control of the corporation by, among other things, obtaining long-term employment contracts for several directors and reducing the number of directors on the board.

> Some courts have suggested that directors may not be sufficiently interested in a transaction to excuse demand, yet are interested enough to be unable to assert the protection of the business judgment rule. . . . On the other hand, formulating different standards for the two issues is . . . difficult. . . . [W]e do not think that we should apply different standards of "interestedness" to cases in which plaintiff has made no demand and to those in which a demand has been made and rejected.

Id. at 785-86 (citations omitted). Since (according to Weiss' argument) directors are too self-interested to terminate shareholder suits, the logical extension of *Lewis* would be to say that they are so interested that demand should be excused in this case as a matter of law.

Although Weiss' argument is superficially alluring, we find it ultimately unpersuasive. First, to the extent that it is based on *Burks, see supra* p. 19, the argument rests on rather uncertain footing. Weiss would read *Burks* as standing for the proposition that directors may not terminate shareholder suits because directors are too interested in advisory fee transactions. While this is not an implausible reading of *Burks*, we do not find the Supreme Court's rationale so easy to discern. Section 36(b)(2) accords the advisory fee actions of directors only "such consideration by the Court as is deemed appropriate under the circumstances." *Burks* understandably concluded that Congress intended less judicial deference to directors' actions regarding advisory fees than is ordinarily associated with the business judgment rule. But we are unable to divine from that opinion a per se rule that investment company directors are presumed to be self-interested, and we decline to adopt Weiss' suggested rule on such a speculative basis.

Weiss also reads too much into our statement in *Cramer, supra*, that the demand requirement and the

business judgment rule are "inextricably linked." 582 F.2d at 274. Rather, as the district court noted below, *see* 516 F. Supp. at 670 n.13, the policies underlying each doctrine are distinct.

The demand requirement originated as a judicially-created device that forced shareholders to exhaust intracorporate remedies before beginning suit. As explained in one of the earliest expositions of the principle:

> [I]t is . . . important that before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part.

Hawes v. Oakland, 104 U.S. 450, 460-61 (1882).[14] The requirement reflects judicial cognizance of the prerogatives and expertise of the directors as stewards of the corporate welfare. One commentator summarized this purpose as follows:

> Forcing shareholders to exhaust intracorporate remedies by first making demand on directors allows the directors a chance to occupy their usual status as managers of the corporation's affairs, giving the corporation an opportunity to take control of a suit that will be brought on its behalf. The demand requirement thus furthers a principle basic to cor-

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14. The Court's holding in *Hawes* was adopted in 1882 as Equity Rule 94, and was modified in 1912 by Equity Rule 27 to allow allegations of the futility of demand. Equity Rule 27 became Federal Rule of Civil Procedure 23(b) which, in turn, was promulgated as Rule 23.1 in 1966.

> porate organization, that the management of the corporation be entrusted to its board of directors.

Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171 (1976). When faced with a demand by a shareholder, the directors have a number of options. They can exercise their discretion to accept the demand and prosecute the action, to resolve the grievance internally without resort to litigation, or to refuse the demand. It is at this point that the business judgment rule comes into play.

The business judgment rule eludes precise categorization, as it assumes different shapes in different settings. *See* Dresenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 Wash. U.L.Q. 311 (1982). In its traditional form, the rule protects directors from personal liability for business decisions by presuming that they acted in good faith and with reasonable care. *See Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (even in a facially self-dealing transaction, the rule assumes directors were "exercising their sound business judgment rather than responding to any personal motivations"), *cert. denied*, 450 U.S. 999 (1981). In shielding directors from the hazards of hindsight challenges to the wisdom of particular decisions, the rule serves two important functions.

> Were courts, with perfect retrospective vision, to second-guess the judgment of officers and directors in their decisionmaking function, they would be injecting themselves into a management role for which they were neither trained nor competent. Such judicial action would also be taking a step to discourage others from performing these desired and essential societal activities. One pragmatic objective of the business judgment rule, then, is to

> keep courts out of a role they are ill-equipped to perform. Another is to encourage others to assume entrepreneurial and risk-taking activities by protecting them against personal liability when they have performed in good faith and with due care, however unfortunate the consequence. Both are of monumental social utility.

Duesenberg, *supra*, 60 Wash. U.L.Q. at 314 (footnotes omitted).

Because the considerations involved in imposing the demand requirement and invoking the business judgment rule are distinct, their applicability is not necessarily coincidental. In fact, this Court so noted in *Cramer*: "[W]hile the demand requirement of Rule 23.1 should be rigorously enforced, we do not think that the business judgment of the directors should be totally insulated from judicial review."[15] The American Law Institute recently expressed a similar view in its proposed Restatement on Principles of Corporate Governance and Structure §7.02, at 270-71 (Tent. Draft No. 1, 1982):

> It is not inconsistent for a court to employ a strict standard with respect to the excusal of demand, but then to refuse to accept a decision by the same board of directors to seek termination of the same action. . . . As some decisions have emphasized, the focus at the demand stage should be on the issue of whether the corporation may take over the suit and either prosecute it or adopt other internal corrective measures, and not on the later question of whether a decision not to sue should be respected

15. At issue in *Cramer* was whether a determination by a disinterested committee of directors that a litigation was not in the best interests of the corporation barred a shareholder suit alleging violations in connection with GTE's foreign payments. The plaintiff had not made a rule 23.1 demand, however, and we affirmed dismissal of the suit on that ground.

> by the court. At the demand stage, the possibility should not be foreclosed that a demand will induce the board to consider issues and crystallize policies which otherwise might not be given attention (e.g., new accounting controls, revised corporate policy statements or even a change in personnel or remuneration). The demand rule can have efficacy even where the board ultimately rejects the action and the court ultimately permits the plaintiff to sue.

In particular, as we noted in *Cramer*, the demand requirement gives management the opportunity to pursue alternative remedies and to avoid unnecessary litigation. 582 F.2d at 275.

We find the distinction particularly important here in light of Congress' clear intent to enhance the independence of directors and their responsibility for advisory fees. The ICA and its amendments were designed to erase potential conflicts of interest inherent in the structure of investment companies by placing the unaffiliated directors in a substantial management role and providing them with authority to act as checks on advisory fees. Congress explicitly empowered the directors to redress challenges to advisory fees by imposing on directors a duty to evaluate the advisory fees and by authorizing them to terminate investment adviser contracts without penalty upon the giving of sixty days notice. 15 U.S.C. §80a-15(a)(3) (1976).[16] To allow shareholders to bypass the directors would undermine the role shaped for directors by the ICA. The opportunity to resolve the

16. As appellees note, the directors can respond to a timely shareholder demand by (1) negotiating a rebate of fees, (2) satisfying the shareholder that the fees are reasonable in terms of the investment services provided, (3) persuading the shareholder that litigation would adversely affect shareholders' interests, (4) accepting the demand and instituting suit, or (5) refusing the demand.

shareholder grievance without resort to litigation may, in fact, be especially important if the directors are not able to terminate the suit. In that event the Rule 23.1 demand provides the only opportunity for the Fund to avert a lawsuit through internal corrective measures.[17]

Finally, the different purposes served by the business judgment rule and the demand requirement show that the wooden transposition of *Lewis* to this statutory context is inappropriate. *Lewis* was concerned with the futility of demand. It involved an inquiry which is "intensely factual" and requires particularized pleading by the plaintiff. *See Vernars v. Young*, 539 F.2d 966, 968 (3d Cir. 1976). In a conventional shareholder suit, the evaluation of the directors' decision to refuse demand or terminate suit is equally factual, and it makes sense, as we stated in *Lewis*, to employ the same standard of interestedness. However, a statutory presumption of interestedness cannot substitute for the factual inquiry needed to determine whether a demand on directors "would be likely to prod them to correct a wrong." *Lewis, supra*, 671 F.2d at 785.[18]

In sum, to read the ICA's statutory scheme as depriving directors of the opportunity to respond to a shareholder grievance would undermine the very pur-

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17. Weiss' argument is also undermined by reference to §16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b) (1976) which he invoked in another context. *See supra* pp. 18-19. In a §16(b) action, where there is no power by the corporation to terminate, *see* Burks v. Lasker, *supra*, 441 U.S. at 484, n.13; *Cramer*, 582 F.2d at 276 n.22, there is an express demand requirement.

18. Relying in part on *Lewis*, the Second Circuit suggested in *Fox v. Reich & Tang, supra*, that the demand requirement would serve no function in the §36(b) context. "[I]t is possible to infer that Congress . . . believed directors would always be so 'interested' that demand would inevitably be 'excused.'" *Id.*, slip op. at n.13. Having already explained our conclusion to the contrary, we simply note the tentative nature of the Second Circuit's language.

pose of the ICA — to strengthen management of the Fund by its independent directors. We attribute no such inconsistent intent to the Congress and conclude that the demand requirement of Rule 23.1 applies to section 36(b) actions.[19]

IV. *THE ALLEGED FUTILITY OF DEMAND*

Weiss contends that even if his section 36(b) claim is subject to the Rule 23.1 demand requirement, such demand would have been futile for all counts of his complaint. The complaint alleges that demand is unnecessary because (1) Shearson and the Adviser control and dominate the Fund and its directors; (2) all of the Fund's directors have participated or acquiesced in the Adviser's breach of fiduciary duty; and (3) the hostility of the directors to the claim was evidenced by the filing of an answer to the initial complaint. Amended Complaint at ¶37.

The district court found that the allegations of the Adviser's and Shearson's control over the directors were inadequate to excuse demand: Weiss failed to provide proof sufficient to overcome the fact that four of the six directors who approved the transaction were not "interested" under the terms of the ICA, 15 U.S.C. §80a-2(a)(19)(1976). The district court also rejected Weiss' effort to use the company's answer to the complaint as evidence of the directors' hostility to suit. Applying the edict of this Court that futility "must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight," *see Cramer v. General Telephone & Electronics Corp., supra*, 582 F.2d at 276, the district court concluded that opposition expressed after suit was filed could not excuse demand.

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19. As noted above, *see supra* p. 14, we must presume that the federal rules apply to this action unless expressly displaced by Congress.

Finally, the court turned to the allegation that the directors' participation in the transaction made demand unnecessary. The court first noted that simply naming the directors as defendants cannot automatically excuse demand on the theory that they would have to decide whether to sue themselves.[20] The court then applied the test enunciated in *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), which states that mere approval of the challenged transaction is insufficient to demonstrate futility of demand unless the complaint alleges facts showing that the transaction was motivated by self-interest or bias. The Court found that Weiss' complaint failed to allege that the directors stood to gain any personal advantage from approval of the advisory contracts; rather, it challenged the directors' action only as a breach of their statutory and common law fiduciary duties. The court accordingly ruled that the pleadings failed to assert a basis for excusing demand.[21] We agree with the analysis of the district court that these allegations are insufficient to excuse demand and affirm on that basis.

V. *DENIAL OF WEISS' MOTION TO REPLEAD AFTER MAKING DEMAND*

Finally, Weiss contends that the district court abused its discretion in refusing him leave to replead after a demand on the Fund's directors. He relies principally on *Markowitz v. Brody*, 90 F.R.D. 542 (S.D.N.Y.

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20. This conclusion was cited with approval in our decision in Lewis v. Curtis, *supra*, 671 F.2d at 785.

21. *Lewis v. Curtis*, *supra*, which was decided after the district court's decision below, does not mandate a different conclusion. As did *Kauffman*, *Lewis* held that the futility of demand turns on the interestedness of the directors rather than the nature of the wrongdoing. *See supra* pp. 20-21. Unlike this case, however, *Lewis* involved specific allegations of a self-interested transaction by all the directors. *See* 671 F.2d at 787.

1981), in which the court stayed dismissal for ninety days in order to allow plaintiff the opportunity to make a demand.

We reject this contention as well. The law of this circuit makes clear that demand after a complaint has been filed is impermissible since it would "reduce the demand requirement of the rule to a meaningless formality." *Schlensky v. Dorsey*, 574 F.2d 131 (3d Cir. 1978). We recognize that application of this rule in this context may seem costly given the Act's limitation on recovery to the excessive fees received during the year immediately prior to the filing of suit. Nevertheless, requiring demand before the filing of suit affords directors "the opportunity to decide in the first instance whether and in what manner action should be taken." *Id.* A demand after suit is filed would usurp this prerogative.

The district court's judgment dismissing the complaint will be affirmed.

GIBBONS, *Circuit Judge*, dissenting.

This is an appeal from a judgment dismissing a multi-count complaint by a shareholder of a money market fund for failure to comply with the demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure.[1] I agree with the majority that the district court properly dismissed all causes of action pleaded in the complaint except that based upon section 36(b) of the Investment Company Act of 1940[2] (ICA). As to that claim I would reverse.

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1. The district court's opinion is reported. Weiss v. Temporary Investment Fund, Inc., 516 F. Supp. 665 (D. Del. 1981). Plaintiff also appeals from the court's denial of his subsequent motion for leave to comply with Rule 23.1 and to file an amended complaint. 520 F. Supp. 1098 (D. Del. 1981).

2. 15 U.S.C. §80a-35(b) (1976).

I.

Plaintiff Melvyn I. Weiss, custodian for his son, Gary M. Weiss, is a shareholder of the Temporary Investment Fund, Inc. (Fund), a no-load, open end, diversified investment company, or "money market fund." In 1980, Weiss brought a shareholder's derivative suit against the Fund, the Provident Institutional Management Corp. (Provident), which acts as the Fund's investment adviser, Shearson Loeb Rhoades, Inc. (Shearson), the Fund's underwriter which also performs administrative duties for the Fund, and seven directors of the Fund. Weiss alleges that Provident and Shearson breached their fiduciary duties under section 36(b) of the ICA by receiving excessive and unreasonable compensation for management services. Weiss further alleges that the various defendants participated in or acquiesced in various breaches of fiduciary obligations owed the Fund and in violations of the Securities Exchange Act of 1934,[3] the Banking Act of 1933,[4] the ICA[5] and the common law. The complaint acknowledges that no demand was made on the directors of the Fund to bring a similar action but alleges that such a demand would be futile. The district court, however, concluded that the plaintiff's failure to make such a demand pursuant to Rule 23.1 was fatal to the action, and dismissed it.[6] Subsequently, Weiss filed a motion for reargument requesting that the court grant him leave to file an

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3. Specifically Section 14(a), 15 U.S.C. §78n (a) (1976), and Rule 14a-9, 17 C.F.R. §240 (1977), adopted thereunder.

4. Specifically Sections 16 and 21, 12 U.S.C. §§24 & 378(a) (1976).

5. Specifically Sections 20(a), 1(b)(2), 15(a) and 15(b), 15 U.S.C. §§80(a)-1-80a-52.

6. The court also dismissed the complaint as to defendant Robertson for insufficient service of process on him. Plaintiff does not challenge that ruling on appeal, so we leave the court's judgment in that respect undisturbed.

amended complaint after making a demand on the directors. He also asked the court to reconsider its determination of non-compliance with Rule 23.1. The district court refused to reconsider, or to grant leave to make a demand.

II.

Rule 23.1 of the Federal Rules of Civil Procedure specifies several pleading requirements "[i]n a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it . . ." Fed. R. Civ. P. 23.1. Among those requirements is that of pleading that a demand has been made on the directors to enforce a right which the corporation may properly assert.[7] Rule 23.1 finds its genesis in Equity Rule 94, 104 U.S. IX (Jan. 23, 1882), which adopted as an Equity Rule the Supreme Court's holding in *Hawes v. Oakland*, 104 U.S. 450 (1881).[8] The Court in *Haws* stated that

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7. The demand requirement of Rule 23.1 reads:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

Fed. R. Civ. P. 23.1.

8. Rule 23.1 was promulgated in 1966. It substantially restated prior Rule 23(b) adopted in 1937 which in turn was a transcription of Equity Rule 27. Equity Rule 27, established in 1912, was itself a slight modification of Equity Rule 94 adopted in 1882. The demand requirement of Equity Rule 94 read:

> [the complaint] must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action.

104 U.S. at X.

> before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court.

104 U.S. at 460-61. This judicially-created demand requirement has survived with slight modification in Rule 23.1. *Hawes* was decided, and Equity Rule 94 was promulgated, during the regime of *Swift v. Tyson*, 41 U.S. (1 Pet.) 1 (1842), when federal courts were free to establish their own equitable remedial jurisprudence. *See* Judiciary Act of 1789, ch. 20, §11, 1 Stat. 926; Process Act of May 8, 1792, ch. 36, §2, 1 Stat. 276 (1850). There was, therefore, no need to decide whether Equity Rule 94, with its demand requirement, was substantive law or merely a procedural provision.

Two developments changed that indifference. One was the 1938 merger of law and equity. The other was the Supreme Court's decision in *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945), applying the *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), choice of law to prevent the application of a federal equitable remedial rule in a diversity case. In light of that holding, the procedural or substantive character of the demand requirement of Rule 23.1 becomes important.

It is clear that Congress did not deal with the *Erie* choice of law question with respect to Rule 23.1. The Federal Rules of Civil Procedure were promulgated by the Supreme Court on December 20, 1937 and reported to Congress on January 3, 1938. *Erie v. Tompkins* was argued to the Court on January 31, 1938, and was decid-

ed in April 1938. Congress adjourned on June 16, 1938 and the Rules took effect September 16, 1938. That chronology of events makes it highly unlikely that Congress examined the remedial versus procedural aspects of the demand clause in Rule 23.1. The origins of Rule 23.1 are of little help, since, as indicated above, the question in 1882 of whether Rule 23.1 was procedural or substantive need not have been asked. We are left, therefore, with the task of construing a Federal Rule of Civil Procedure in such a manner as to ensure its validity in actions involving state law claims. *See, e.g., Hanna v. Plumer*, 380 U.S. 460 (1965).

This court has held that a plaintiff-shareholder's obligation to make a demand on the corporate directors before pursuing a derivative claim is inextricably linked to the state law business judgment rule. *Cramer v. GTE Corp.*, 582 F.2d 259, 274 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). "Once the shareholder has made a demand upon the directors, the directors are then able to determine whether in their opinion a suit on behalf of the corporation would comport with the best interests of the corporation." *Id.* at 275. The directors can pursue remedies alternative to litigation, can terminate meritless causes of action, and can determine whether litigation cost and other adverse effects on business relationships with potential defendants would outweigh any potential recovery from the lawsuit. The directors' decision to allow suit or not is insulated from judicial review by the business judgment rule. The rule is a substantive one, intended to enforce the elected management's responsibility for operating the corporation, while insulating it from liability for good faith mistakes made while performing its duties. *See Briggs v. Spaulding*, 141 U.S. 132, 146-148 (1891).

Subsequent to our decision in *Cramer v. GTE Corp.*, 582 F.2d 259, the Supreme Court had occasion to make explicit what was implicit in the *Cramer* discussion: that

the substantive business judgment rule is a rule of state, not federal law. In *Burks v. Lasker*, 441 U.S. 471 (1979), the Court considered whether state or federal law governs the power of a corporation's directors to terminate a derivative suit, and ruled:

> We hold today that federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the [federal statutes relied upon].

Id. at 486.

It is clear, then, that the business judgment rule which Rule 23.1 enforces is not a product of federal substantive law. If the rule is to be considered valid under *Erie*, it must now be regarded as the procedural means whereby federal courts ensure that the underlying substantive state law business judgment rule is implemented. The Rule 23.1 demand requirement is, therefore, a procedural device that since *Erie* is animated by the existence of an underlying substantive content. As a necessary corollary, if it is determined that for a given cause of action the directors do not have the substantive power under the relevant law to prevent or to terminate the derivative action, then the demand requirement of Rule 23.1 is not activated since its application would serve no meaningful purpose. *A fortiori*, if the cause of action is one which the corporation could not bring on its own behalf, Rule 23.1 cannot apply. This is plain from the text of the rule, and would be required as a matter of choice of law in any event.

The issue, thus, is the choice of law to be made in determining whether the underlying cause of action admits to the application of a state law business judgment rule which a Rule 23.1 demand would effectuate. In diversity cases or for pendent state law claims, the relevant substantive law is constitutionally mandated to be state law and, hence, a Rule 23.1 demand requirement is al-

ways triggered by the state business judgment rule. In non-diversity cases, *Erie* is of no relevance with respect to the elements of the cause of action. Yet as the Supreme Court makes clear in *Burks v. Lasker*, 441 U.S. 471, federal courts ordinarily look to state corporate law for the existence of an applicable business judgment rule. The federal courts' adoption of state corporate law when deciding the scope of the corporate directors' powers to terminate or to prevent derivative suits is merely a rule of statutory construction. It is based on a judicial determination that Congress in creating federal causes of action does so against a background of state corporate law to which federal courts must refer even though the cause of action is based on federal law. *See Burks v. Lasker*, 441 U.S. at 478-79. *See also Johnson v. Railway Express Agency*, 421 U.S. 454, 465 (1975). That general proposition is qualified, however, by the requirement that the state may not contravene the policies of the federal law with respect to which the business judgment question arises. *See, e.g., Burks v. Lasker*, 441 U.S. at 478-79. The demand requirement under Rule 23.1 is applicable even to federal causes of action because the state law business judgment rule applies unless the relevant federal law preempts exercise of business judgment. A demand is required only if the corporation may assert the cause of action relied upon, and the substantive law giving rise to the cause of action permits the directors to terminate it in the exercise of their business judgment.

III.

For all causes of action asserted by Weiss except that under section 36(b) of the ICA, a demand is required because they depend on state law, or on non-preemptive federal law, and the directors may exercise business judgment to take over or to terminate the claim. Of course, the business judgment rule is inapplicable, as a matter of state law, where the directors' judg-

ment is not in good faith, is the product of self-dealing or is made under the influence of persons suspected of wrongdoing. Moreover, the directors' discretion is not unbounded, and courts may examine their action to determine whether it is within the permissible bounds of that discretion.

Weiss urges that for all counts a demand on the Fund directors should be excused as futile. Like the majority, I am unconvinced. We previously stated that:

> The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring anti-trust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way.

Landy v. FDIC, 486 F.2d 139, 149 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), *quoting Ash v. International Business Machines, Inc.*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966). Weiss' allegations do not, however, state with particularity reasons why the directors would not be able properly to make the choice whether to sue. "Instead of being 'a statement of appropriate and convincing facts' that a demand would have been futile, [plaintiff's allegations constitute] merely a vague, conclusory statement." *Landy v. Federal Deposit Insurance Corporation*, 486 F.2d at 148 (citation omitted). Thus I agree that the District Court did not err in dismissing those state law and federal law claims as to which the state law business judgment rule clearly applies.

IV.

Whether Rule 23.1 applies to a claim asserted under section 36(b) of the ICA depends on (1) whether such a claim is one belonging to the corporation, and (2) if it is, whether it is one as to which the state law business judgment rule may as a matter of federal substantive law apply. Section 36(b) is part of a group of amendments, enacted in 1970, to the Investment Company Act of 1940. Congress decided that mutual funds deserved special regulation because:

> Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees.
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> . . .
>
> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. Rep. No. 184, 91st Cong., 2d Sess. 5, *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901.

The primary method by which Congress sought to control the peculiar problems of mutual funds was the

requirement that at least 40% of fund directors be independent. These "unaffiliated" directors are given the main burden of supervising the management and the finances of the fund. *See Burks v. Lasker*, 441 U.S. at 482-83. In certain areas of the funds' dealings, however, Congress did not leave matters to final resolution by the unaffiliated directors. Rather, it mandated alternative forms of regulation. One area of special concern is the compensation paid by a mutual fund to its adviser. The Senate Report vividly points up that concern:

> In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.
>
> Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means *for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty*. This bill would make it clear that, as a matter of Federal law, the investment adviser or mutual fund management company has a fiduciary duty with respect to mutual fund shareholders. It provides an effective method whereby *the courts can determine* whether there has been a breach of this duty by the adviser or by certain other persons with respect to their compensation from the fund.

S. Rep. No. 184, 91st Cong., 2d Sess. 2, *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4898 (emphasis added). Referring to what is now section 36(b), the Senate Report observes:

> This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of man-

agement fees. It does, however, authorize *the court to determine* whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee.

* * *

Directors of the fund, including the independent directors, have an important role in the management fee area. A responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored. While *the ultimate responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court*, approval of the management fee by the directors and shareholder ratification is to be given such weight as the court deems appropriate in the circumstances of a particular case.

* * *

Under this proposed legislation either the SEC or a shareholder may sue in court on a complaint that a mutual fund's management fees involve a breach of fiduciary duty.

Id. at 4902-03 (emphasis added). This report plainly discloses that while the court must afford deference to the views of fund directors, the ultimate resonsibility for deciding whether the fees are so high as to be regarded as a breach of fiduciary duty is judicial. Nowhere in the legislative history of section 36 is there any suggestion that fund directors — even unaffiliated directors — can seek such a judicial determination. Only the SEC and shareholders are indicated. With that illuminating legislative history in mind we turn to the statute as enacted.

Prior to 1970, section 36 of the ICA authorized the SEC to seek an injunction barring persons in a fiduciary relationship to a fund from acting in such capacity if they were in the five years prior to the action guilty of "gross misconduct or gross abuse of trust." Investment

Companies Act of 1940, Pub. L. No. 76-768, §36, 54 Stat. 841 (1940). No other relief was authorized. In 1970 section 36 was amended to eliminate the "gross misconduct or gross abuse of trust" standard so as to authorize an SEC suit if the fiduciary "has engaged . . . or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company. . . ." 15 U.S.C. §80a-35(a) (1976). The relief available in an SEC suit was also enlarged so as to permit not only orders barring future participation as a fiduciary, but also "such injunctive or other relief against such person as may be reasonable in the circumstances. . . ."

At the same time an entirely new remedy, dealing specifically with adviser compensation, was added in a new subsection 36(b).[9] It authorizes an action "by the

9. Section 36(b) reads:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:
>
> (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.
>
> (2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing

Commission, or by a security holder of such registered investment company, against such investment adviser, . . . for breach of a fiduciary duty in respect of . . . compensation. . . ." 15 U.S.C. §80a-35(b) (1976).

There are several significant features to the 1970 amendment to section 36. In the 1940 Act, the Section dealt only with SEC enforcement, and the sole remedy was to bar the offender from the investment company industry. Section 36 created no cause of action, express or implied, in favor of a fund. The 1970 amendments both carried forward and broadened the SEC enforcement powers in section 36(a). Plainly the "other relief" available under that section would include an accounting which would inure to the benefit of a defrauded fund — not to the SEC. Yet there is no suggestion that the fund could plead a cause of action for the same relief which would be available under section 36(a) in an action by the SEC. As Judge Tyler observed:

> section 36(a) of the Investment Company Act, 15 U.S.C. §80a-35(a), authorizes the SEC to bring ac-

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NOTE (Continued)

for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

tions against certain individuals or companies for breaches of fiduciary duty involving personal misconduct. Section 36(a), however, authorizes an action by the SEC, not by private individuals. Although this should not be read to prohibit suits by individuals when other sections of the Investment Company Act are violated, when only a general breach of fiduciary duty is alleged, a private suit should more properly be brought in state court.

Monheit v. Carter, 376 F. Supp. 334, 342 (S.D.N.Y. 1974). A section 36(a) action by the SEC may be considered "derivative" in the sense that it may right a wrong committed against a fund, and may even obtain relief in favor of a fund, but it certainly is not "derivative" in the sense that the section 36(a) cause of action belongs to the fund in the first instance. It is only to such a cause of action that Rule 23.1 has any application.

Turning to the new cause of action created in section 36(b) with respect to adviser compensation, we cannot, in determining legislative intention, overlook the significant fact that Congress chose to house it not in a separate provision, but as an amendment to a section which from the beginning dealt with public rather than

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(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

15 U.S.C. §80a-35(b) (1976).

private enforcement. While Subsection 36(b) does not say in as many words "a state law business judgment rule cannot terminate an action under this section," permitting the directors of a fund to exercise business judgment in order to prevent an SEC action would be inconsistent with the provision that

> [i]n any such action approval by the board of directors of such investment company of such compensation or payments . . . and ratification or approval of such compensation or payments . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances.

15 U.S.C. §80a-35(b)(2) (1976). Whereas under the typical state law business judgment rule the disinterested directors' decision exercised in good faith binds the court, under section 36(b) the court must make an independent judgment. Moreover, no distinction is made, in this respect, between an action brought by the SEC and one brought by a shareholder. It seems to me, therefore, that by creating the SEC cause of action and the shareholder action in the same sentence, and housing both in a section of the ICA which historically dealt with public rather than private enforcement, Congress disclosed a rather clear intention that the stockholder action be a variety of private attorney general action, *i.e.*, outside the control of the fund's directors. That intention is strongly confirmed by the excerpts from the Senate Report quoted above. It is confirmed, moreover, by the absence of any provision in section 36(a) or (b) for a cause of action by the fund itself.

The majority concludes, despite the absence of any provision in section 36 for a suit by the fund, that the cause of action does belong to the fund, and thus falls within the terms of Rule 23.1. To affirm, the majority must make this assertion, for if the security holders' cause of action is not one which the fund could assert, it

is not derivative, at least not in the sense of Rule 23.1. The majority, however, points to no legislative history suggesting that the fund can bring a Section 36(b) suit. I do not believe the omission of a provision for suits by the fund itself was inadvertent. If the fund were authorized to sue, a litigated or, more significantly, a consent judgment would raise serious questions of the preclusive effect of the judgment on any subsequent action by the SEC or a shareholder.[10] The most likely interpretation is that Congress intended to create a cause of action solely by the SEC, or by a shareholder acting in a private attorney general capacity, so as to preclude consent judgments entered into by the fund and which might have the effect of precluding the judicial review of director judgment mandated by 15 U.S.C. §80a-35(b)(2). Such an intention is suggested by legislative history indicating that one of the reasons for expressly allowing suit to be brought by either the SEC or a security holder was the congressional assessment that the fund directors could not effectively deal with adviser compensation. The Senate Report stated that the 1970 amendments to the ICA were predicated on the SEC's 1966 report and recommendations on investment companies. "Public Policy Implication of Investment Company Growth," Report of the Committee on Interstate and Foreign Commerce, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966). In that report, the SEC indicated its judgment that:

> The unaffiliated directors, as the only potentially disinterested persons in the management of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of

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10. *See* 13 Fletcher Cyc. Corp. §6043 (Permanent Ed.) and cases cited therein.

the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders. *But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation.*

The unaffiliated directors are not in a position to bargain on an equal footing with the adviser on matters of such crucial importance to it. They are not free, as a practical matter, to terminate established management relationships when differences arise over the advisory fees or other compensation. This reflects, in large part, the adviser-underwriter permeation of investment company activities to an extent that makes rupture of the existing relationships a difficult and complex step for most companies. *For these reasons, arm's-length bargaining between the unaffiliated directors and the managers on these matters is a wholly unrealistic alternative.*

Id. at 148 (emphasis supplied). It seems unlikely that Congress intended that the unaffiliated directors, by bringing and settling a section 36(b) suit, could accomplish the very result that the SEC regarded as an unrealistic alternative. Thus I do not believe that section 36(b) grants "a right which may properly be asserted by [the fund]." Fed. R. Civ. P. 23.1.

Even if, contrary to its plain language and probable purpose, section 36(b) were to be construed as creating "a right which may properly be asserted by [the fund]," *id.*, there would still remain the question whether the disinterested directors of the fund may, in the exercise of business judgment, prevent a judicial examination, sought by the SEC or a security holder, of advisers fees.

Other aspects of the section support a negative answer. There is a one year period of limitation. 15 U.S.C. §80a-35(b)(3). Such a short period suggests that intervention by fund directors was not contemplated, for if a claim were to be delayed until the directors were notified and were given a chance to consider the advisability of a given action, the statutory period would quickly run out. By adjusting fees prospectively, while delaying the decision on whether to sue for fees already paid, fund managers could significantly reduce recovery. The normal delays incident to corporate decision-making are incompatible with a one year period of limitation, and director involvement therefore must have been discounted by Congress. Another aspect suggesting the inapplicability of the business judgment rule to section 36(b) is the circumscribed nature of a 36(b) cause of action. Recovery is limited to actual damages capped by the total compensation paid. Recovery can only be had from the recipients of compensation, and liability cannot be the predicate for an injunction severing an investment adviser from a fund. These limitations on the section 36(b) remedy minimize the intrusion by the Section upon the directors' responsibility to operate the fund, and suggest the absence of any serious erosion of the management responsibility conferred by state law.

I conclude, therefore, that the Rule 23.1 demand requirement does not apply to a section 36(b) action, because the Section does not provide "a right which may properly be asserted by [the fund]", and because even assuming such a right, section 36(b)(2) preempts any state law business judgment rule which would be furthered by the demand requirement.

This interpretation of section 36(b) has been anticipated by the Supreme Court. In *Burks v. Lasker*, 441 U.S. at 484, the Court stated that:

> [w]hen Congress . . . intend[ed] to prevent board action from cutting off derivative suits, it said

> so expressly. Section 36(b), . . ., 15 U.S.C. §80a-35 (b)(2), added to the [Investment Company] Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

The holding in *Burks v. Lasker* that the state law business judgment rule permits independent directors to terminate derivative suits based on federal statutes so long as the rule is consistent with the policies of the federal statutes in issue, puts the quoted statement in context. The application of business judgment to terminate a section 36(b) suit is inconsistent with the policy of that section. The majority treats the statement of the *Burks* Court as a mere *dictum* which this court can disregard. If it is *dictum*, it is *dictum* of the most compelling sort. The quoted passage was not a passing reference, but was integrally tied to the Court's holding and reasoning. The Court supported its position about fund directors' power to terminate other derivative actions by pointing to section 36(b) as an example of Congress, in clear terms, preventing director veto. The *Burks* reasoning depends, therefore, on the quoted *dictum* with respect to section 36(b) and it cannot be disregarded by this intermediate court.

The Court of Appeals for the Second Circuit, which in matters relating to the federal securities law carries particular authority, confronted with the identical problem, reached the same conclusion with respect to section 36(b) as I reach. Moreover it concluded, as I do, that Rule 23.1 is inapplicable because, as *Burks v. Lasker* teaches, it is designed to implement the business judgment rule only in cases where directors can control a lawsuit. *Fox v. Reich & Tang, Inc. and Daily Income Fund, Inc.*, No. 82-7296, slip op. (2d Cir. Oct. 26, 1982).

Despite the unambiguous statement in *Burks v. Lasker* that section 36(b) is an instance in which Congress has precluded the application of any state law busi-

ness judgment rule, the Court of Appeals for the First Circuit recently affirmed the dismissal of a section 36(b) action for failure to plead compliance with the demand requirement of Rule 23.1. *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 1982). With deference, I am not persuaded by that court's interpretation of the statute, its treatment of the legislative history, or its reading of *Burks v. Lasker*. Thus while the *Grossman v. Johnson* opinion supports the defendants, I would not follow it. I find particularly unpersuasive the *Grossman* court's treatment of 15 U.S.C. §80a 35(b)(2) (1976). While acknowledging that the section "can easily be read to give the court, rather than the directors, the ultimate power to decide the propriety of the fees," it reasoned that a demand would not be futile, because the directors' "decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgable disagreement with the demand might be deemed worthy by the court of grave consideration under §36(b)(2)." 674 F.2d at 121. Section 36(b)(2) explicitly directs the court to give the directors' views "such consideration . . . as is deemed appropriate under all the circumstances." 15 U.S.C. §80a 356(b)(2) (1976). Obviously those views can be made known during the course of the lawsuit. But the court's obligation to take the directors' views into account does not, even under the *Grossman* court's analysis permit the directors to terminate or to prohibit the security holders' action. Thus the demand which that court required served no purpose but to delay judicial inquiry and to insulate more payments to the investment adviser from such judicial review by operation of the short statute of limitations in section 36(b)(3). Since the directors' business judgment is to be considered relevant to a section 36(b) claim only to the limited extent that the court must take the directors' views into account, any state law business judgment rule is clearly supplanted. What must be reconciled is section 36(b)(2) and Rule 23.1. No federal policy

suggests itself which would support a mechanistic application of the demand requirement when the only purpose to be served is to give the directors an opportunity to make their views known to the court. That can be done in an appropriate pleading.

The majority's analysis, relying on *Cort v. Ash*, 422 U.S. 66 (1975), is as flawed as that of the *Grossman* court. It must be noted that the *Cort v. Ash* test for implying causes of action in favor of parties not mentioned in a federal statute has been significantly contradicted by subsequent cases such as *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 639 (1981), and *Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n*, 453 U.S. 1, 13 (1981). We must look for a clear indication of congressional intent to afford such a cause of action. Neither the statutory language nor its legislative history contains any such indication of an intent to permit an investment fund to control a section 36(b) claim and thereby insulate it from judicial review. Indeed, as I have outlined above, a contrary intent is the most likely.

Finally, the majority's reliance on *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825 (1982), is an extreme misinterpretation of that authority. The *Curran* case found a congressional intention, when amending the Commodity Exchange Act by the Commodity Futures Trading Act of 1974, to recognize that prior to the amendment lower federal courts had implied causes of action from the former although it did not expressly provide for them. No cause of action had been implied for the entirely new cause of action created in section 36(b) because that cause of action did not exist at the time Congress last spoke. The suggestion that the *Curran* analysis applies because a fund could bring a common law action against an adviser for corporate waste demonstrates confusion about the nature of the problem which the *Curran* Court addressed. Common law causes of action are not "implied" from federal stat-

utes. They exist as a matter of state law. Moreover, the suggestion ignores the clear intention, in section 36(b), to create a right to recover overcharges which could not be recovered under the state common law of waste.

V.

Since the governing federal law does not permit direct control over section 36(b) actions, it supplants the applicable state law business judgment rule. No section 36(b) policy would be advanced by applying the demand requirement of Rule 23.1 to section 36(b) actions. Absent an underlying substantive rule of law which the pleading requirements of Rule 23.1 would advance, their application serves no useful purpose. The trial court erred, therefore, in dismissing the complaint for failure to plead that a demand had been made on the directors. The judgment appealed from should be affirmed insofar as it dismissed all claims other than that predicated on section 36(b), but reversed insofar as it dismissed that claim.[11] Thus I dissent from the judgment of this court insofar as it affirms the dismissal of the section 36(b) claim.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

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11. I also agree that the district court did not abuse its discretion by denying plaintiff leave to make subsequent demand on the directors and to replead.

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